

**SECURITIES AND EXCHANGE COMMISSION**  
(Release No. 34-55638; File No. SR-NASD-2003-141)

April 16, 2007

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities

**I. Introduction**

On September 17, 2003, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to adopt an additional mark-up policy for transactions in debt securities other than municipal securities. NASD filed amendments to the proposed rule change on June 29, 2004 and February 17, 2005.<sup>3</sup> 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.<sup>4</sup>

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

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

<sup>3</sup> Amendment No. 1 to SR-NASD-2003-141 made technical changes to the original rule filing. Amendment No. 2 to SR-NASD-2003-141 superseded the original rule filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 51338 (March 9, 2005), 70 FR 12764 (March 15, 2005).

The Commission received six comments on the proposal.<sup>5</sup> NASD submitted a response to these comments on October 4, 2005,<sup>6</sup> and filed Amendment Nos. 3, 4, and 5, which also addressed the comments and proposed responsive amendments.<sup>7</sup> Amendment No. 5 replaced the rule filing in its entirety. The proposed rule change, as amended, was published for comment in the Federal Register on November 28, 2006.<sup>8</sup> The Commission received four additional comments on the proposal.<sup>9</sup> NASD submitted a response to these additional comments on January 12, 2007.<sup>10</sup> All of the comments received by the Commission in response to Amendment Nos. 3, 4, and 5 are available on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). This

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<sup>5</sup> See letters from Paul Scheurer dated April 5, 2005; Micah S. Green, President, and Michele C. David, Vice President and Assistant General Counsel, The Bond Market Association dated April 5, 2005; William C. Caccamise, General Counsel, Banc of America Securities LLC dated April 14, 2005; Edward F. Greene, General Counsel, Corporate and Investment Banking, Citigroup Global Markets Inc. ("CGMI") dated April 14, 2005; John R. Gimand, Chair, Senior Executives Group, and David L. Murphy, Chair, Joint Buyside/Sellside Regulatory Developments, Senior Executives Group, The Asset Manager's Forum dated June 28, 2005; Debbie Cunningham, Chair, Investor Committee, and Bianca Russo, Chair, Regulatory Committee, American Securitization Forum dated July 26, 2005.

<sup>6</sup> See letter from Sharon K. Zackula, Associate General Counsel, NASD dated October 4, 2005.

<sup>7</sup> Amendment Nos. 3 and 4 made technical changes to the rule filing.

<sup>8</sup> See Securities Exchange Act Release No. 54799 (Nov. 21, 2006), 71 FR 68856 (Nov. 28, 2006) ("2006 Notice").

<sup>9</sup> See letters from Mary Kuan, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association ("SIFMA") dated January 3, 2007 ("SIFMA 1 Letter"); Robbin Conner, Vice President and Assistant General Counsel, SIFMA dated January 4, 2007 ("SIFMA 2 Letter"); Edward F. Greene, General Counsel, Corporate and Investment Banking, CGMI dated January 5, 2007 ("CGMI 2 Letter"); Robyn A. Huffman, Managing Director, Associate General Counsel, Goldman, Sachs & Co. ("Goldman Sachs") dated January 5, 2007 ("Goldman Sachs Letter").

<sup>10</sup> See letter from Sharon Zackula, Associate General Counsel, NASD dated January 12, 2007.

order approves the proposed rule change, as modified by Amendment Nos. 1 through 5.

## **II. Background and Description of the Proposal**

When a securities dealer acting in a principal capacity sells a security to a customer, the dealer generally “marks up” the security, increasing the total price the customer pays. When buying a security from a customer, a dealer acting as a principal generally “marks down” the security, reducing the total proceeds the customer receives.<sup>11</sup> NASD Rule 2440, “Fair Prices and Commissions,” requires dealers to buy and sell securities at a fair price to customers. NASD IM-2440, “Mark-Up Policy,” provides additional guidance on mark-ups, mark-downs, and fair pricing of securities transactions with customers.<sup>12</sup> Both NASD Rule 2440 and IM-2440 apply to all over-the-counter transactions, including transactions in debt securities, and require that when a customer buys a security from a dealer, the customer’s total purchase price, and the mark-up included in the price, be fair and reasonable.<sup>13</sup>

The Proposed Interpretation, IM-2440-2, “Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities (‘Proposed Interpretation’),”<sup>14</sup> would provide

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<sup>11</sup> The terms “mark-up” and “mark-down” are not found in NASD Rule 2440, but are used in IM-2440. Statements in this order regarding mark-ups also apply generally to mark-downs unless mark-downs are discussed specifically in a separate statement.

<sup>12</sup> For example, IM-2440 provides that an NASD member would violate NASD Rule 2440, as well as NASD Rule 2110 related to standards of commercial honor and principles of trade, if it enters into a transaction with a customer in any security at a price not reasonably related to the security’s current market price (or charges an unreasonable commission).

<sup>13</sup> 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.

<sup>14</sup> NASD also proposes to re-number IM-2440 as IM-2240-1. Accordingly, IM-2440 is referred to elsewhere in this order as IM-2440-1.

additional guidance on mark-ups in debt securities transactions (other than municipal securities transactions).<sup>15</sup> The Proposed Interpretation particularly addresses a key aspect of determining whether a mark-up is fair and reasonable - correctly identifying the security's prevailing market price. It sets forth a sequence of criteria and procedures that a dealer must consider when determining the prevailing market price. The text of the Proposed Interpretation is available on NASD's Web site ([www.nasd.com](http://www.nasd.com)), at NASD's principal office, and at the Commission's Public Reference Room.

A. Presumptive Use of Contemporaneous Cost

The Proposed Interpretation provides that when a dealer calculates a mark-up or mark-down, the best measure of the prevailing market price of the security presumptively is the dealer's contemporaneous cost or proceeds.<sup>16</sup> The dealer may look to countervailing evidence of the prevailing market price only if the dealer, when selling a security, made no contemporaneous purchases in the security or can show that, in the particular circumstances, the dealer's

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<sup>15</sup> MSRB rule G-30, "Prices and Commissions," applies to transactions in municipal securities, and requires a municipal securities dealer engaging in a transaction as a principal with a customer to buy or sell securities at an aggregate price that is "fair and reasonable."

<sup>16</sup> See Proposed IM-2440-2(b)(1). For these purposes, the contemporaneous cost or proceeds must be consistent with NASD pricing rules. See *id.* Current IM-2440-1(a)(3) provides: "In the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security." NASD states that contemporaneous cost would not be a reliable indicator of the prevailing market price for purposes of determining a mark-up and mark-down in circumstances where the dealer violates NASD Rule 2320 (Best Execution and Interpositioning) because in those situations the price would not reflect market forces. See 2006 Notice at n.15.

contemporaneous cost is not indicative of the prevailing market price.<sup>17</sup>

For purposes of the Proposed Interpretation with respect to a mark-up, 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 price for the security."<sup>18</sup> For a mark-down, a dealer's proceeds are 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."<sup>19</sup>

#### B. Criteria for Overcoming the Presumption

The Proposed Interpretation recognizes that in some circumstances a dealer may seek to overcome the presumption that its own contemporaneous cost is the prevailing market price of the subject security for determining a mark-up. A dealer may seek to overcome the presumption, and show that contemporaneous cost is not indicative of the prevailing market price, in the following three instances: (i) if interest rates changed enough following the dealer's contemporaneous transaction to reasonably cause a change in the debt security's pricing; (ii) if the credit quality of the debt security changed significantly after the dealer's contemporaneous transaction; or (iii) if news was issued or otherwise distributed, and known to the marketplace,

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<sup>17</sup> See Proposed IM-2440-2(b)(2). When buying a security from a customer, the dealer may look to countervailing evidence of the prevailing market price only if 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. See id.

<sup>18</sup> See Proposed IM-2440-2(b)(3).

<sup>19</sup> See id.

that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.<sup>20</sup>

### C. Pricing Alternatives to Contemporaneous Cost

When the dealer has established that its cost no longer is contemporaneous, or when the dealer has presented evidence that is sufficient to overcome the presumption that its contemporaneous cost provides the best measure of the prevailing market price, the Proposed Interpretation sets forth a process that the dealer must follow to determine the prevailing market price. In those circumstances, the dealer must first consider a "Hierarchy" of three factors in order. The first and most important factor is the pricing of any contemporaneous inter-dealer transactions in the same security.<sup>21</sup> In the absence of contemporaneous inter-dealer trades, the second factor provides that a dealer must consider the prices of contemporaneous dealer purchases in the same security from institutional accounts with which any dealer regularly effects transactions in that security.<sup>22</sup> If contemporaneous inter-dealer trades and dealer-institutional trades in the same security are not available,<sup>23</sup> then the third factor provides that, for actively traded securities, a dealer must look to contemporaneous bid quotations for the security

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<sup>20</sup> See Proposed IM-2440-2(b)(4).

<sup>21</sup> See Proposed IM-2440-2(b)(5)(A).

<sup>22</sup> See Proposed IM-2440-2(b)(5)(B). Contemporaneous dealer sales with those institutional accounts would be used to calculate a mark-down.

<sup>23</sup> NASD has explained that 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 because such transactions would be subject to the same defect. See 2006 Notice at n.30.

made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.<sup>24</sup>

The Proposed Interpretation further provides that the relative weight to be given to the comparison transactions or quotations discussed above depends on the facts and circumstances, including whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction and the timeliness of the information.<sup>25</sup>

#### D. Additional Alternatives to Contemporaneous Cost

If none of the above three “Hierarchy” factors are available, the Proposed Interpretation provides that the dealer may then consider a non-exclusive list of four factors in trying to establish the prevailing market price.<sup>26</sup> In contrast to the three “Hierarchy” factors, a dealer may consider these factors in any order.

- Prices of contemporaneous inter-dealer transactions in a “similar” security or prices of contemporaneous dealer transactions in a “similar” security with institutional accounts with which any dealer regularly effects transactions in the “similar” security;<sup>27</sup>

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<sup>24</sup> For a mark-down, a dealer must look to contemporaneous bid offers for the security. See Proposed IM-2440-2(b)(5)(C).

<sup>25</sup> See Proposed IM-2440-2(b)(5).

<sup>26</sup> See Proposed IM-2440-2(b)(6).

<sup>27</sup> For this factor and the third factor, the dealer should look to purchase transactions with institutional accounts when determining mark-ups, and to sale transactions with institutional accounts when determining mark-downs.

- Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” securities;
- Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in “similar” securities; and
- Yields calculated from validated contemporaneous inter-dealer bid quotations in “similar” securities.<sup>28</sup>

The Proposed Interpretation provides that the relative weight of the pricing information obtained from these factors depends on the facts and circumstances surrounding the comparison transaction. These include whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the fourth factor listed above, the relative spread of the quotations in the “similar” security to the quotations in the subject security.<sup>29</sup> NASD explains that when applying one or more of the four factors, a dealer must consider that the ultimate evidentiary issue is whether use of the factor will correctly identify the prevailing market price of the security.<sup>30</sup>

For purposes of these four factors, the Proposed Interpretation provides that a “similar” security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment. At a minimum, a dealer must be able to fairly estimate the market yield

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<sup>28</sup> For this factor, the dealer should look to inter-dealer bids when determining mark-ups, and to inter-dealer offers when determining mark-downs.

<sup>29</sup> See Proposed IM-2440-2(b)(6).

<sup>30</sup> See 2006 Notice.



for the subject security from the yields of similar securities.<sup>31</sup> The Proposed Interpretation also sets forth a list of non-exclusive factors to use in identifying similar securities:

(a) Credit quality considerations, such as whether the security is issued by the same or a similar entity, bears the same or a similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security, including significant recent information of either issuer that is not yet incorporated in credit ratings, such as changes in ratings outlooks;<sup>32</sup>

(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;<sup>33</sup>

(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;<sup>34</sup> and

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<sup>31</sup> See Proposed IM-2440-2(c)(1). Where a security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security. See id.

<sup>32</sup> See Proposed IM-2440-2(c)(2)(A).

<sup>33</sup> See Proposed IM-2440-2(c)(2)(B).

<sup>34</sup> See Proposed IM-2440-2(c)(2)(C).

(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.<sup>35</sup>

E. Use of Economic Models

If it is not possible to obtain information concerning the prevailing market price of the subject security by applying any of the factors discussed above, the Proposed Interpretation provides that the dealer or NASD may consider as a factor 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 all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods).<sup>36</sup> NASD emphasizes that dealers may not use an economic model to establish the prevailing market price for mark-up purposes except in the limited instances when none of the factors discussed above apply.<sup>37</sup>

F. 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.”

Thus, absent extraordinary circumstances, members considering the yields of similar securities

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<sup>35</sup> See Proposed IM-2440-2(c)(2)(D).

In some cases, there are no similar securities. When a debt security’s value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including the issuer’s creditworthiness and its ability and willingness to meet the specific obligations of the security, in most cases other securities will not be sufficiently similar and may not be used to establish prevailing market price of the subject security. See Proposed IM-2440-2(c)(3).

<sup>36</sup> See Proposed IM-2440-2(b)(7).

<sup>37</sup> See 2006 Notice.

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.<sup>38</sup>

#### G. QIB Exception

The Proposed Interpretation would except a qualified institutional buyer (“QIB”)<sup>39</sup> that is purchasing or selling a non-investment grade debt security from the definition of “customer,” when the dealer has determined 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.<sup>40</sup> This exception from the “customer” definition also would apply to NASD Rule 2440 and IM-2440-1.<sup>41</sup> NASD explained that there is less need to protect large institutional customers because they often have sufficient knowledge of the market.<sup>42</sup> NASD also stated that applying the Proposed Interpretation to generally illiquid market sectors often may yield little or

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<sup>38</sup> See Proposed IM-2440-2(b)(8).

<sup>39</sup> The Proposed Interpretation adopts the definition of QIB in Rule 144A of the Securities Act of 1933, 17 C.F.R. 230.144A. See Proposed IM-2440-2(b)(9).

<sup>40</sup> See Proposed IM-2440-2(b)(9).

<sup>41</sup> See id. For purposes of NASD Rule 2440, IM-2440-1 and the Proposed Interpretation, “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. See id.

<sup>42</sup> See id.

no pricing information useful for calculating mark-ups.<sup>43</sup>

### **III. Summary of Comments on Amendment Nos. 3, 4, and 5**

In soliciting comments on Amendment Nos. 3 through 5, the Commission stated that it would consider comments it previously received, and that commenters could reiterate or cross-reference these previous comments.<sup>44</sup> The Commission has considered all of the comments it received in response to both the original proposal, as amended by Amendment Nos. 1 and 2, and the proposed rule change, as amended by Amendment Nos. 3, 4, and 5, including commenters' reiteration of, and cross-references to, previously submitted comments. While the summary below refers to some comments previously submitted, it primarily discusses comments received on Amendment Nos. 3 through 5.

#### **A. General Comments**

All of the commenters commended NASD on changes made to the proposed rule in Amendment Nos. 3 through 5, and expressed particular support for the QIB exception.<sup>45</sup> One

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<sup>43</sup> See id.

<sup>44</sup> See 2006 Notice at n. 46.

<sup>45</sup> See SIFMA 1 Letter; SIFMA 2 Letter; CGMI Letter; Goldman Sachs Letter. The CGMI and Goldman Sachs Letters both expressed general support for the comments addressed in both of the SIFMA Letters.

commenter noted the significance of the proposal and urged the Commission to adopt it as quickly as possible.<sup>46</sup>

#### B. Comments Related to the Proposed QIB Exception

While all of the commenters supported the QIB exception, they also urged NASD to extend it to transactions in other securities. Commenters suggested that the exception should apply to privately placed unregistered debt securities, stating that those securities have less pricing information and are less liquid than registered bonds, and emphasizing the sophistication of QIBs.<sup>47</sup> Commenters also suggested extending the exception to transactions in all securitized products, stating that applying the Proposed Interpretation to volatile markets could deter dealers from providing liquidity.<sup>48</sup>

In response to these comments, NASD stated that it would like to gain regulatory experience by monitoring how the market adjusts to the use of differentiated regulation for QIBs before it considers extending the exception to transactions in other securities. NASD noted in

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<sup>46</sup> See Goldman Sachs Letter. While this commenter suggested a number of particular changes to the proposal, it emphasized the need for the Proposed Interpretation to be adopted quickly to give more clarity to market participants. The commenter also noted that while the Proposed Interpretation is an “important first step” in developing mark-up guidance, it should not be the final stage of the process. The commenter further asked the Commission and NASD to continue working with the industry to address additional issues as they become apparent with the application of the Proposed Interpretation. See id.

<sup>47</sup> See SIFMA 1 Letter; SIFMA 2 Letter; CGMI Letter; Goldman Sachs Letter.

<sup>48</sup> See SIFMA 2 Letter; Goldman Sachs Letter. In the alternative, SIFMA urged NASD to extend the exception to any private bond transactions in a securitized product. It also called for more flexibility with regard to the use of credit ratings and economic models. See SIFMA 2 Letter.

particular that the exception is a significant expansion of its approach of generally extending the requirements of all rules to all customers without differentiation.

C. Comments Related to the Former “Size” Proposal

An industry group asked NASD to reconsider its “size” proposal, which NASD eliminated when it proposed the QIB exception in Amendment No. 5.<sup>49</sup> The size proposal would have allowed a dealer to show that its contemporaneous cost was not indicative of prevailing market price when a large or small transaction was executed at a price away from the prevailing market price, as evidenced by certain contemporaneous transactions. The commenter stated that the use of discounted or premium price results from small or large trades to compute subsequent mark-ups would place dealers in a difficult position, requiring them to sell bonds at a price that is lower than the prevailing market price, or buy bonds at a price that is higher than the prevailing market price.

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<sup>49</sup> See SIFMA 1 Letter. The “size” proposal was included in Amendment Nos. 3 and 4.

Goldman Sachs also commented on the withdrawal of the “size” proposal and asked NASD to confirm that the premium or discount that may occur with a large block trade can be considered when using the block trade price to determine prevailing for a subsequent trade, noting that it does not think the QIB exception adequately addresses this issue. See Goldman Sachs Letter.

NASD responded that it had concluded that the size proposal would not be an appropriate basis to justify a shift from contemporaneous cost to determine the prevailing market price, in part due to customer protection concerns.<sup>50</sup>

D. Comments on “News”

An industry group supported the provision in the Proposed Interpretation recognizing that news may affect the perceived value of a security subsequent to a trade, but believed that such news could be distributed through a variety of channels and may not be widely available to the marketplace.<sup>51</sup> The commenter also stated that news should include information that may impact the price of an issuer’s debt securities, such as news about a different issuer.<sup>52</sup>

In response, NASD clarified that news that may affect the perceived value of a debt security may include information about other issuers. NASD further stated, however, that a dealer may not use news that is distributed through narrow channels and not broadly disseminated to the public because such narrowly disseminated information may not have a material impact upon market pricing.

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<sup>50</sup> NASD stated that the size proposal raises significant investor protection concerns when large institutional sized positions are purchased and resold in small retail-sized transactions. NASD further noted that it had eliminated the size proposal in recognition that a dealer that is a market maker (as defined in Section 3(a)(38) of the Act) may avail itself of the spread before employing a mark-up. NASD also reiterated that if the dealer is not a market maker, it must use contemporaneous cost or other prices as provided in the Proposed Interpretation.

<sup>51</sup> See SIFMA 1 Letter. In response to initial comments on the proposal, NASD provided, through Amendment Nos. 3 through 5, that news that had an effect on the perceived value of a debt security after a dealer’s contemporaneous transaction may justify shifting from contemporaneous cost to other cost values to determine the prevailing market price.

<sup>52</sup> See id.

#### E. Comments on Other Issues

Commenters also discussed a number of other issues related to the Proposed Interpretation. In particular, commenters criticized the “Hierarchy” of factors set forth in the Proposed Interpretation as inflexible and impractical,<sup>53</sup> requested additional guidance on the meaning of contemporaneous cost,<sup>54</sup> and requested that NASD clarify in the Proposed Interpretation that dealers may be market makers in debt markets.<sup>55</sup> NASD responded that it believes these issues were thoroughly vetted during the comment process related to this rule filing, noting that in addition to the comment periods under this rule filing, these issues had been addressed in a preceding rule filing that was superseded by this proposal.<sup>56</sup>

#### IV. **Discussion and Commission Findings**

The Commission has reviewed carefully the Proposed Interpretation, the comments on the proposed rule change, as amended, and NASD’s response to the comments, and believes that

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<sup>53</sup> See id.

<sup>54</sup> See SIFMA 1 Letter; Goldman Sachs Letter.

<sup>55</sup> See SIFMA 1 Letter.

<sup>56</sup> See NASD Notice to Members 94-62 (August 1994) and the comments submitted thereto; Securities Exchange Act Release No. 40511 (Sept. 30, 1998), 63 FR 54169 (Oct. 8, 1998) (soliciting comments on SR-NASD-97-61) and comments submitted thereto. NASD withdrew SR-NASD-97-61 when it filed SR-NASD-2003-141.

It should be noted that in its earlier response to comments, NASD provided additional guidance on some of these issues. NASD addressed comments on contemporaneous cost by amending the Proposed Interpretation to provide that the meaning of “contemporaneous” turns upon whether the transaction was close enough in time to be reasonably reflected in the security’s market price. NASD also addressed comments on “market maker” status by stating that it adopted the term “market maker” as defined in Section 3(a)(38) of the Act for purposes of the proposal and that it will apply the statutory definition without broadening the limits imposed by current legal precedent.



NASD has responded appropriately to the concerns raised by the commenters. The Commission finds that the Proposed Interpretation, as amended, is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities association, and, in particular, with Section 15A(b)(6) of the Act, which requires, among other things, that the rules of a national securities association 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.<sup>57</sup>

The Proposed Interpretation is designed to provide guidance to dealers for calculating fair prices and mark-ups in compliance with NASD Rule 2440 in a way that is consistent with long-standing Commission and judicial precedent regarding fair mark-ups.<sup>58</sup> The Proposed Interpretation provides a framework that specifically establishes contemporaneous cost as the presumptive prevailing market price, but also identifies certain dynamic factors that are relevant to whether contemporaneous cost or alternative values provide the most appropriate measure of prevailing market price. The Commission believes that the factors that govern when a dealer may depart from contemporaneous cost and that set forth alternative measures the dealer may use are reasonably designed to provide greater certainty to dealers and investors while providing an

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<sup>57</sup> 15 U.S.C. 78o-3(b)(6). In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>58</sup> See e.g., F.B. Horner & Assocs. v. SEC, 994 F.2d 61 (2d Cir. 1993) (citing Barnett v. SEC, 319 F.2d 340 (8th Cir. 1963) (absent evidence to the contrary, the Commission is entitled to consider a broker-dealer's contemporaneous cost as evidence of current market price)); In the Matter of Alstead, Dempsey & Co., 47 S.E.C. 1034, 1984 SEC LEXIS 1847 (April 5, 1984); In the Matter of DMR Securities, Inc., 47 S.E.C. 350, 1980 SEC LEXIS 1071 (July 21, 1980); see also Securities Exchange Act Release No. 24368 (April 21, 1987), 52 FR 15575 (April 29, 1987) (notice to broker-dealers concerning disclosure requirements for mark-ups on zero-coupon securities).

appropriate level of flexibility for dealers to consider alternative market factors when pricing debt securities.

While we are mindful of the important issues raised by commenters, we believe that NASD has reasonably addressed them. For example, the QIB exception should provide dealers with flexibility for transactions that present greater pricing challenges without undermining the investor protection benefits of the Proposed Interpretation. While it declined to expand this exception in response to comments at this time, NASD committed to monitor how the market adjusts to the use of differentiated regulation for QIBs in relation to mark-ups.<sup>59</sup>

The Commission also believes NASD has adequately addressed and responded to other issues raised by commenters throughout the comment process.<sup>60</sup> NASD's submission of two sets of responsive comments and five amendments to this rule filing reflects a deliberative and collaborative process ultimately focused on providing comprehensive and flexible mark-up guidance that contemplates dealers' practical experience in the debt markets. It is unavoidable that determining the baseline for a fair and reasonable mark-up will be inherently challenging.

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<sup>59</sup> NASD similarly provided a practical response to requests for clarification of news that may have an effect on the perceived value of a debt security. NASD clarified that such news may include information about other issuers, but drew an appropriate line by stating that dealers may not rely on news that is not broadly disseminated to the public because of the limited market impact of such information. NASD also responded reasonably to requests for the restoration of the "size" proposal, in light of the customer protection concerns it identified.

<sup>60</sup> For example, NASD took a reasonable position stating that it adopts the statutory definition of market maker in Section 3(a)(38) of the Act. Under current legal precedent, a dealer is not and should not be considered a market maker merely because the dealer takes risk positions or devotes substantial capital to provide liquidity. Rather, to be considered a market maker, a dealer must meet the legal requirements set forth in the Act, which provides, in relevant part, that a dealer must hold itself out as being willing to buy and sell a security for its own account on a regular or continuous basis. See Exchange Act Section 38(a)(38), 15 U.S.C. 78c(a)(38).

By recognizing the facts-and-circumstances nature of the analysis and by setting forth a logical series of factors to be used when a dealer departs from contemporaneous cost, however, NASD has proposed an approach for identifying the prevailing market price of a debt security that is reasonable and practical in addressing the interests of dealers and investors.

**V. Conclusion**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>61</sup> that the proposed rule change (SR-NASD-2003-141), as modified by Amendment Nos. 1 through 5, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>62</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>61</sup> 15 U.S.C. 78s(b)(2)

<sup>62</sup> 17 CFR 200.30-3(a)(12).