

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51457; File No. SR-NASD-2004-135)

March 31, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Disclosure and Consent Requirements when Trading on a Net Basis with Customers

Pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (“Act”)² and Rule 19b-4 thereunder,³ notice is hereby given that on September 1, 2004, the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On February 16, 2005, NASD filed Amendment No. 1 to the proposed rule change.⁴ On February 25, 2005, NASD filed Amendment No. 2 to the proposed rule change.⁵ On March 21, 2005, NASD filed Amendment No. 3 to the proposed rule change.⁶ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 15 U.S.C. 78a et seq.

³ 17 CFR 240.19b-4.

⁴ In Amendment No. 1, among other things, NASD deleted each instance of the words “or similar” in the phrase “on a ‘net’ or similar basis” in proposed new Rule 2441.

⁵ In Amendment No. 2, NASD removed underlining that inadvertently had been applied to paragraph (e) of proposed new Rule 2441 as it appeared in Exhibit 4 to Amendment No. 1.

⁶ In Amendment No. 3, among other things, NASD modified proposed new Rule 2441 by substituting “adviser” for “advisor” in paragraph (b) and substituting “customer whose account qualifies” for “customer that qualifies” in paragraph (d).

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is filing a proposed rule to require disclosure and consent when trading on a net basis with customers. Proposed new language is in *italics*.

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2441. Net Transactions with Customers

(a) Prior to executing a transaction with a customer on a "net" basis as defined in paragraph (d) below, a member must provide disclosure to and obtain consent from the customer as provided in this Rule.

(b) With respect to non-institutional customers, the member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order. For those non-institutional customers that have granted trading discretion to a fiduciary (e.g. an investment adviser), a member is permitted to obtain such consent from the fiduciary.

(c) With respect to institutional customers, a member may obtain customer consent through the use of a negative consent letter prior to executing a transaction for or with the customer on a "net" basis. If evidencing the consent of an institutional customer through the use of a negative consent letter, before obtaining such consent, a member must clearly disclose to the institutional customer in writing the terms and conditions for handling the customer order(s) and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If no objection from the customer is received, then the member may reasonably conclude that the institutional customer has consented to the member trading on a

“net” basis with the customer and the member may rely on such letter for all of the customer’s orders (unless instructed otherwise) pursuant to this Rule.

(d) For purposes of this Rule, (1) “institutional customer” shall mean a customer whose account qualifies as an “institutional account” under Rule 3110(c)(4); and (2) “net” transaction shall mean a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.

(e) Members must retain and preserve all documentation relating to consent obtained pursuant to this Rule in accordance with Rule 3110(a).

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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

A riskless principal transaction is a transaction in which a member, after having received a customer order executes an offsetting transaction, as principal, with another customer or broker-dealer to fill that customer order and both transactions are executed at the same price. NASD announced amendments to the trade reporting rules that required qualifying riskless

principal transactions of market makers to be the subject of a single trade report.⁷ Prior to these amendments, both legs of a riskless principal transaction were reported. The amendments stipulated that a riskless principal transaction qualified for a single trade report where each side of the trade was executed at the same price, exclusive of any mark-up, mark-down, commission equivalent or other fee. The trade reporting amendments in connection with riskless principal transactions were important for several reasons including the accuracy of the order audit trail and the transactional integrity of the volume of last sales reported to the consolidated tape.

In view of the purpose and importance of these amendments, NASD also addressed the treatment of net trading.⁸ Net trading is generally defined as a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price. The difference between the execution price given to the customer in a net transaction and the price of the offsetting transaction to the contra-side (other customer or broker-dealer) is in effect the market maker's compensation.⁹ In sum, net trading is the transactional equivalent of a riskless principal transaction with the exception that the prices reported on both sides of the transactions are not the same. Consequently, each side of a net transaction is trade reported at its respective price.

In view of the regulatory interest in fostering a single trade report for riskless principal transactions, NASD announced that a member "working an order" (that is, finding an offsetting

⁷ See Notice to Members 99-65 (August 1999).

⁸ Id. See also Notice to Members 01-85 (December 2001) (Question & Answer No. 4).

⁹ Exchange Act Rule 10b-10(a)(2)(ii)(B) does not require such compensation to be separately disclosed on the customer confirmation by market makers.

execution or series of executions for a customer order that the member holds) for an institutional account or in connection with a block-size order, would be presumed to be handling the worked order on a qualifying riskless principal basis with the order matched off on each side at the same price (exclusive of any mark-up or mark-down, commission equivalent or other fee) unless the customer has specifically requested that the order be traded on a net basis, at a different price.¹⁰ Accordingly, NASD and Nasdaq recognized that there are times when a market maker will trade on a net basis with an institution and that such market maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price, provided that the customer has requested that the order be traded on a net basis and such arrangement satisfies the member's best execution obligation and is consistent with SEC and NASD statements regarding the matching of limit and market orders.

In response to this guidance provided by NASD and Nasdaq, members were concerned that the presumption to trade at the same price did not reflect the fact that institutional customers have historically expected firms to trade with them on a net basis. Members also were concerned that such a presumption would place them in the difficult position of having to rebut it on nearly every institutional trade. Members requested guidance on how to document this understanding, and asked for permission to use "negative consent" letters, citing logistical difficulties with obtaining affirmative consent from customers. In response, Nasdaq, after consultation with both the SEC and NASD regulatory staff, stated that members may use negative consent letters to evidence a customer's request to trade on a net basis, as long as the letter met specified

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Id.

conditions, including that the letter clearly disclosed the terms and conditions for handling the order and the customer was provided a meaningful opportunity to object to the letter.¹¹

Because it has been the NASD staff's understanding that net trading typically only occurs at the request of institutional customers, NASD has not addressed specifically in prior Notices to Members a member's obligations when trading on a net basis with respect to non-institutional customers. However, given that there is a presumption that a member cannot trade on a net basis with a customer unless the customer has specifically requested it, NASD staff has taken the position that members may only trade with non-institutional customers on a net basis after obtaining their informed consent on an order-by-order basis.

To clarify and codify the NASD staff's positions, both with respect to institutional and non-institutional customers, the proposed rule change would require a member to obtain consent from a customer prior to executing a transaction with a customer on a "net" basis. Members would be required to retain and preserve all documentation relating to the consent obtained pursuant to the proposed rule in accordance with Rule 3110(a).

With respect to non-institutional customers,¹² the member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order. For those non-institutional customers that have granted

¹¹ See SEC Release No. 34-43103 (August 1, 2000); 65 FR 48774 (August 9, 2000). See also Notice to Members 00-79 (November 2000).

¹² For purposes of the proposed rule, "institutional customer" shall mean a customer whose account qualifies as an "institutional account" under Rule 3110(c)(4). A non-institutional customer, therefore, would be a customer whose account does not qualify as an institutional account under Rule 3110(c)(4).

trading discretion to a fiduciary, such as an investment adviser, a member would be permitted to obtain such consent from the fiduciary.

With respect to institutional customers, a member also must obtain consent, but it may be evidenced through the use of a negative consent letter. If using a negative consent letter, the member must clearly disclose to the institutional customer in the letter the terms and conditions for handling the customer order(s) and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis in the letter. If no objection is received, then the member may reasonably conclude that the institutional customer has consented to the terms and conditions in the letter and requested that the member trade on a net basis and the member may rely on such letter for all of the customer's orders (unless instructed otherwise).

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's 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 the proposed rule will promote investor protection by codifying the requirement that members provide disclosure and obtain customer consent when trading on a net basis.

(B) Self-Regulatory Organization's Statement on Burden on Competition

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

(C) Self-Regulatory Organization's Statement on Comments on the Proposed

Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

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

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NASD-2004-135 on the subject line.

Paper Comments

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

All submissions should refer to File No. SR-NASD-2004-135. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, please use only one method. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are

filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-NASD-2004-135 and should be submitted on or before [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland
Deputy Secretary

¹³ 17 CFR 200.30-3(a)(12).