

Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-FICC-2005-14. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 100 F Street, NE., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of FICC and on FICC's Web site at <http://www.ficc.com>. 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-FICC-2005-14 and should be submitted on or before November 16, 2005.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52637; File No. SR-NASD-2004-026]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Amendments No. 3 and 4 to Proposed Rule Change To Amend NASD Rule 2320(a) Governing Best Execution

October 19, 2005.

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> notice is hereby given that on June 22 and September 22, 2005, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission" or "SEC") Amendments No. 3 and 4 to the proposed rule change as described in Items I, II, and III below which Items have substantially been prepared by the NASD. The proposed rule change, incorporating Amendments No. 1 and 2, was published for comment in the **Federal Register** on February 25, 2005.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended by Amendments No. 3 and 4 from interested persons.

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

In response to comments on the original proposal, NASD is proposing additional amendments to Rule 2320(a) ("Best Execution Rule"). Below is the text of the proposed rule change marked to show changes from the text that was published previously.<sup>4</sup> Proposed deletions are in brackets. The discussion section of this notice focuses on the changes made in Amendments No. 3 and 4. For an explanation of the original filing, see the release cited in footnote 3.

#### 2300. TRANSACTIONS WITH CUSTOMERS

##### 2320. Best Execution and Interpositioning

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

- (1) The character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
- (2) The size and type of transaction;
- (3) The number of markets checked;
- (4) Accessibility of the quotation; and

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

(b) through (g) No change.

\* \* \* \* \*

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

###### Background

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

NASD believes that not applying the Best Execution Rule to recipient members is contrary to both the interests of the investing public and the general intent of the Best Execution Rule.

###### Proposal

NASD filed Amendments No. 3 and 4 in response to the commenters' concerns about how the proposed rule change would apply to the debt markets

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

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

<sup>3</sup> See Securities Exchange Act Release No. 51229 (Feb. 18, 2005), 70 FR 9416.

<sup>4</sup> *Id.*

<sup>10</sup> CFR 200.30-3(a)(12).

and in instances where another broker-dealer is simply executing a customer order against a member's quote. Amendment No. 3 deletes proposed references to market centers and instead uses the term "market." NASD is making this change in response to comments that suggest that the term "market center" would: (1) Create an unfair competitive disparity in the equity market; and (2) create confusion and problems of interpretation, application, and enforcement in the debt market. While the term "market" has been in the text of NASD Rule 2320 since its adoption, it is an undefined term. Accordingly, NASD is providing interpretive guidance that states that, for purposes of NASD Rule 2320, the term "market" or "markets" should be interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of best execution.

In Amendment No. 3, NASD also is providing interpretive guidance concerning how the Best Execution Rule should be applied in the debt market with respect to one of the factors used to determine if a member has used reasonable diligence: Accessibility of the quotation. When quotations are available, such as for certain liquid debt securities, NASD will consider the "accessibility of such quotations" when examining whether a member has used reasonable diligence. For purposes of debt, the term "quotation" refers to either dollar (or other currency) pricing or yield pricing.<sup>5</sup>

Amendment No. 4 clarified that a member's duty to provide best execution in any transaction "for or with a customer of another broker-dealer" does not apply in instances when another broker-dealer is simply executing a customer order against the member's quote. Stated in another manner, the duty to provide best execution to customer orders received

from other broker-dealers arises only when an order is routed from the broker-dealer to the member for the purpose of order handling and execution. This clarification is intended to draw a distinction between those situations in which the member is acting solely as the buyer or seller in connection with orders presented by a broker-dealer against the member's quote, as opposed to those circumstances in which the member is accepting order flow from another broker-dealer for the purpose of facilitating the handling and execution of such orders.

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,<sup>6</sup> in general, and with Section 15A(b)(6) of the Act,<sup>7</sup> in particular, which requires that NASD rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

### B. Self-Regulatory Organization's Statement on Burden on Competition

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

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

On February 25, 2005, the SEC published SR-NASD-2004-026 for comment in the **Federal Register**.<sup>8</sup> The SEC received three comment letters in response to the publication of the rule proposal in the **Federal Register**.<sup>9</sup> On

June 22, 2005, the NASD responded to the comments.<sup>10</sup> BMA responded to the NASD's response.<sup>11</sup>

The BMA submitted a comment letter stating, among other things, its belief that NASD only considered equities trading when drafting the proposed rule change.<sup>12</sup> Specifically, BMA states that NASD's proposed change of terminology in an attempt to clarify and modernize the Best Execution Rule exemplifies how the rule change was drafted to address equities trading only and states further that changing "inter-dealer" markets to "market centers" has no meaning in the context of the bond market. BMA believes the proposal is inappropriate for fixed income securities and, if adopted, would exacerbate existing difficulties with regard to bond trading. In addition, BMA believes applying the Best Execution Rule, as amended, is impractical, unfair, anti-competitive, unworkable in the case of the bond market, and inconsistent with a customer's reasonable expectations of how its orders will be handled.

NASD appreciates the comments of BMA but does not find them to be persuasive. Essentially, BMA is advocating, for a number of reasons, that the Best Execution Rule is not applicable to the debt market. However, the terms of NASD Rule 2320 have never been limited to equity securities and the consistency of this observation is expressed in NASD Rule 0116 in which the Best Execution Rule, among others, is made applicable to transactions and business activities relating to exempted securities (other than municipal securities) conducted by members and associated persons.<sup>13</sup>

("Instinet") dated March 22, 2005 ("Instinet Letter"); Michele C. David, Vice President and Assistant General Counsel, The Bond Market Association ("BMA") dated April 5, 2005 ("BMA Letter"); all of which were addressed to Jonathan G. Katz, Secretary, Commission.

<sup>10</sup> See Amendment No. 3.

<sup>11</sup> See letter from Marjorie Gross, Senior Vice President and Regulatory Counsel, BMA to Jonathan G. Katz, Secretary Commission, dated September 6, 2005 ("BMA Letter 2").

<sup>12</sup> NASD did not intend to only consider equity trading when drafting this proposal. In this rule proposal, NASD is again clarifying that the Best Execution Rule is applicable to the debt market, and is providing additional interpretive guidance. Specifically, NASD is providing interpretive guidance with respect to the "accessibility of the quotations" reasonable diligence factor and the application of this factor in the debt market. When quotations are available, such as for certain liquid debt securities, NASD will consider the "accessibility of such quotations" when examining whether a member has used due diligence. In such instances, the term "quotation" refers to either dollar (or other currency) pricing or yield pricing.

<sup>13</sup> See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Approval of SR-NASD-2000-38).

<sup>5</sup> NASD notes, however, that accessibility is only one of the non-exhaustive reasonable diligence factors set out in NASD Rule 2320. In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

<sup>6</sup> 15 U.S.C. 78o-3.

<sup>7</sup> 15 U.S.C. 78o-3(b)(6).

<sup>8</sup> See footnote 3, supra.

<sup>9</sup> See letters from Amal Aly, Vice President and Associate General Counsel, and Ann Vlcek, Vice President and Associate General Counsel, Securities Industry Association ("SIA") dated March 18, 2005 ("SIA Letter"); Paul A. Merolla, Executive Vice President and General Counsel, Instinet Group, Inc.

Further, BMA asserts that the term "market center" is an equity term and cannot be applied in the context of debt. The NASD acknowledges that the term "market center" has traditionally been used in connection with certain equity securities. For example, Rule 600(b)(38) under the Act,<sup>14</sup> which is applicable to national market system securities, defined "market center" as any exchange market maker, over-the-counter (OTC) market maker, alternative trading system, national securities exchange, or national securities association. In seeking to modernize the Best Execution Rule, NASD sought a recognized term that was aimed broadly at capturing order execution venues. However, in response to comments, including BMA's concerns that use of this term may introduce confusion in the debt market, NASD has determined to amend the Best Execution Rule to instead use the term "market." It should be noted, as discussed above, that the term "market" or "markets" for purposes of NASD Rule 2320, should be interpreted broadly to include a variety of different venues, including but not limited to market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge; it is not NASD's intention to mandate that certain trading venues have less relevance than others in the course of best execution.

BMA also believes imposing a best execution obligation on a "downstream" chain of dealers is impractical, unfair, anti-competitive, and unworkable in the case of the bond market. BMA argues that such an obligation should not be imposed on recipient broker-dealers because there is no pre-trade quote transparency, no mandatory firm quote obligation, and no uniform, regulated inter-market and inter-dealer linkage.<sup>15</sup>

BMA fails to recognize that the Best Execution Rule has been in place since 1968. It was adopted at a time when the market structure of the OTC market was quite different. There was significantly less market transparency. Trading decisions and pricing information were based upon telephone and wire quotations as well as quotations in the National Quotation Bureau sheet. At that time, in response to a recommendation made in Chapter VII of the Report of Special Study of Securities Markets of the Securities and Exchange Commission,<sup>16</sup> NASD had recently adopted a policy with respect to firmness of quotations. Furthermore, no uniform, regulated inter-market, inter-dealer linkage existed. The fact is that the Best Execution Rule has been in force since the time when the OTC equity market more closely resembled the current fixed income market.

The principles embodied in the Best Execution Rule have evolved over time with changes in technology and the structure of the financial markets.<sup>17</sup> This evolution arises because the standard in the Best Execution Rule is one of "reasonable diligence" that is assessed by examining specific factors including "the character of the market for the security." Accordingly, the determination as to whether a member has satisfied its best execution obligations necessarily involves a "facts and circumstances" analysis. In sum, in its refutation of the best execution obligation in the context of the debt markets, BMA is incorrect as a matter of law and regulation. Moreover, BMA's policy attack on this important investor protection safeguard is fatally

Notwithstanding these observations, they do not obviate the application of the Best Execution Rule in wholesale fashion. As discussed subsequently in the text, NASD's Best Execution Rule looks at a number of factors, including the character of the market for the security, to determine whether a member or associated person(s) has used reasonable diligence. Accordingly, it can be applied in a variety of different markets that can possess divergent characteristics, including the U.S. debt market.

<sup>16</sup> See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 674 (1963).

<sup>17</sup> The SEC has expressly recognized the evolving nature of the best execution obligations of broker-dealers. See, e.g., Final Rules, 61 FR at 48322-23 ("The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become 'reasonably available.'"). Accordingly, the principles embodied in the text of the Best Execution Rule are applicable to a variety of different market structures and evolve as the market structure for a particular type of security evolves.

undermined by the elasticity of NASD Rule 2320 in its recognition that the character of the market will be among the reasonable diligence factors in the execution of the obligation.

BMA posits that extending best execution obligations to customers of another broker-dealer is inconsistent with a customer's reasonable expectations of how its orders will be handled because the customer would not have the same expectations of the chain of "unknown" intermediary firms involved in its transactions. NASD strongly disagrees with BMA.<sup>18</sup> BMA's assertion that customers' expectations would somehow be different when an "unknown" intermediary is involved is inconsistent with the generally recognized principle that customers generally seek their own economic gain and that broker-dealers have a corresponding duty to use reasonable efforts to maximize the economic benefits for their customers.<sup>19</sup> There is nothing in the case law that suggests that a broker-dealer's determination to use an unrelated intermediary should relieve its duties in this regard. NASD strongly believes that customers are entitled to receive equivalent best execution protections without regard to whether their order is executed by the originating broker-dealer or routed to or through another broker-dealer for execution.

The SIA and Instinet submitted comment letters that, taken together, promote the view that a recipient broker-dealer's compliance with the terms and conditions of the order, as communicated by the originating broker-dealer, solely, should constitute satisfaction of its best execution obligation with regard to such routed orders. SIA and Instinet assert that this is appropriate because the recipient broker-dealer is not in the same position as the routing firm to weigh the relative

<sup>18</sup> It has been NASD's consistent position since at least 1963 that "the integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed." See, Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 624 (1963).

<sup>19</sup> See, e.g., *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998) (en banc) (citation omitted), cert. denied sub nom., *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Kravitz*, 525 U.S. 811 (1998). The Court, in the context of an agency relationship, recognized that customers seek their own economic gain. Specifically, the Court stated that " \* \* \* the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction."

<sup>14</sup> 17 CFR 242.600(b)(38).

<sup>15</sup> BMA notes in its comment letter that the fixed income market is, in fact, not a single market, but in effect, several different markets ranging from the U.S. Treasury market, where dealer quotations may be very representative of market prices and quotations on trading systems may be executable, to the corporate bond market, where large and active issuers may be actively quoted and where screens may provide good transparency for certain securities of active issuers (but not for other securities or issuers), to the market for distressed and emerging market paper and derivative instruments, such as structured notes, where there may be limited trading, quoting or transparency.

importance of various factors related to each customer, as it usually has no knowledge of the actual customer.

NASD disagrees with the arguments of SIA and Instinet. The recipient member is certainly entitled to rely on the routing member to understand the terms of the order absent any other direct contact with the customer; with that allowance noted, the recipient member is not at any further disadvantage in complying with the terms of Rule NASD 2320, and, consequently, investor protection requires that recipient members must be subject to all of the relevant reasonable diligence factors in determining whether best execution has occurred as a matter of fact and circumstance.

Instinet also asserted that the proposal would create an unfair competitive disparity between otherwise similarly situated market centers that execute orders on an electronic agency basis because the proposed rule would not apply to market centers operated by NASD and other self-regulatory organizations ("SROs"). Instinet requests that NASD revise the proposal to exclude member-operated Electronic Communication Networks and Alternative Trading Systems that interact with orders on a fully automated basis, or else apply the same obligations under the proposal to the market centers operated by NASD and other SROs.<sup>20</sup> As noted above, NASD has responded to this comment, as well as BMA's, by deleting proposed references to market centers and simply using the term "market." For purposes of NASD Rule 2320, this term should be interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security. Finally, in response to the commenters' concerns, in Amendment No. 4, NASD clarified that a member's duty to provide best execution to customer orders received from other broker-dealers "arises only when an order is routed from the broker-dealer to the member for the purpose of order handling and

execution" and does not arise when another broker-dealer is simply executing against a member's quote.

### 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-026 on the subject line.

#### *Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2004-026. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in

the Commission's Public Reference Room. Copies of the 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-2004-026 and should be submitted on or before November 16, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

**Jonathan G. Katz,**  
*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52645; File No. SR-NASD-2005-116]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change To Modify Nasdaq's Auditor Peer Review Requirement

October 20, 2005.

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> notice is hereby given that on September 29, 2005, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq proposes to modify NASD Rule 4350(k) to reflect changes to the oversight of auditors mandated by the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act")<sup>3</sup> and to make a conforming amendment to NASD Rule 4200(a). Nasdaq will implement the proposed rule immediately upon

<sup>20</sup> Instinet also claims that, in light of Regulation NMS' effects on interaction among market centers and the potential conflicts and interpretive issues, NASD's proposal could be interpreted to require a market center (the recipient broker-dealer) to consider routing an order to another market center displaying a better price even though the originating broker-dealer already has indicated that it has attempted to access such interest. NASD's Best Execution Rule contains a number of factors that are examined to determine whether a member or associated person has used reasonable diligence, including "accessibility of the quotation." Accordingly, the facts and circumstances surrounding the "accessibility of the quotations" would be considered to the extent they are appropriate.

<sup>21</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> Pub. L. 107-204, 116 Stat. 745 (2002).