

September 16, 2003

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-2003-141
Additional Mark-Up Policy For Transactions in Debt Securities**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Sharon K. Zackula, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8985; e-mail sharon.zackula@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2003-141
Consists of 29 Pages
September 16, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to establish a second interpretation, proposed IM-2440-2, to Rule 2440. Proposed IM-2440-2 provides additional mark-up guidance for transactions in debt securities, except municipal securities. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

IM-2440-1. Mark-Up Policy

The question of fair mark-ups or spreads is one which has been raised from the earliest days of the Association. No definitive answer can be given and no interpretation can be all-inclusive for the obvious reason that what might be considered fair in one transaction could be unfair in another transaction because of different circumstances. In 1943, the Association’s Board adopted what has become known as the “5% Policy” to be applied to transactions executed for customers. It was based upon studies demonstrating that the large majority of customer transactions were effected at a mark-up of 5% or less. The Policy has been reviewed by the Board of Governors on numerous occasions and each time the Board has reaffirmed the philosophy expressed in 1943. Pursuant thereto, and in accordance with Article VII, Section 1(a)(ii) of the By-Laws, the Board has adopted the following interpretation under Rule 2440.

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.

(a) through (d) No change.

IM-2440-2. Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities¹

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

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, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost or contemporaneous proceeds.

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* 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* or can show that in the particular circumstances the dealer's *contemporaneous proceeds* are not indicative of the prevailing market price.

When debt securities trade inactively, inter-dealer transactions may be rare or non-existent, and establishing the prevailing market price in a transaction involving an inactively traded debt security may be difficult.

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 must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost provides the best measure of the prevailing market price. In this respect, factors that NASD believes may be taken into consideration in establishing prevailing market price for a mark-up or a mark-down include, but are not limited to:

1. Prices of any contemporaneous inter-dealer transactions in the security in question or prices of dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a "similar" security, as defined below;
2. Contemporaneous inter-dealer quotations or other indications of price (hereinafter, "quotations") for the security in question made through an inter-dealer mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;
3. Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
4. Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in the same or "similar" securities; and
5. Yields calculated from validated contemporaneous inter-dealer quotations in "similar" securities.

The relative importance of the factors listed above depends on the facts and circumstances surrounding the particular transaction, such as the order size, timeliness of the information, and the relative spread of the quotations. In addition, because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will not have much, if any, weight or relevance. For example, in considering yields of "similar" securities in Items 3, 4 and 5 above, 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.

A "similar" security should be sufficiently similar to the security under review 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 security under review 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.

The degree to which a security is "similar" as that term is used in Items 1, 3, 4, and 5 above, may be determined by factors that include but are not limited to:

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;

B. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

C. General structural characteristics 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; and

D. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

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.

¹. The interpretation does not apply to transactions in municipal securities. Statements regarding mark-ups also apply generally to mark-downs.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on July 30, 2003, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of

Governors had an opportunity to review the proposed rule change at its meeting on July 31, 2003. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be not more than 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Sharon K. Zackula, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD at (202) 728-8985.

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

(a) Purpose

Under Rule 2440, "Fair Prices and Commissions," members are required to sell securities to a customer at a fair price.¹ 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. IM-2440, "Mark-Up

¹ Rule 2440 specifically provides that a member is required to 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"

Policy,” provides additional guidance on mark-ups and fair pricing of securities transactions with customers.²

Under Rule 2440 and IM-2440, when a customer buys a security from the dealer, the customer’s total purchase price, and the mark-up included in the price, must be fair and reasonable. Similarly, when the 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 is fair and reasonable is correctly identifying the *prevailing market price* of the security, which is the basis from which the mark-up is calculated.

The proposed interpretation, “IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities,” provides additional guidance on mark-ups in debt securities transactions, except municipal securities transactions.³ 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 can it be considered in determining the prevailing market price.

Prevailing Market Price.

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 is presumptively the

² 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.

³ Municipal Securities Rulemaking Board (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.”

dealer's contemporaneous cost (or contemporaneous proceeds). 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 or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price. 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 or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

The statement that a dealer's contemporaneous cost is presumptively the prevailing market price of a security is a restatement of a fundamental principle found in existing law in court cases and SEC and NASD decisions regarding mark-ups. The presumption that contemporaneous cost is the best evidence of prevailing market price is found in many cases, and, as early as 1992, its specific applicability to debt securities transactions was addressed by the SEC in F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993) ("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." F.B. Horner, 50 S.E.C. at 1065-1066. The basis for the standard was also restated. "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." F.B. Horner, 50 S.E.C. at 1066. The proposal contemplates that for a

dealer to be deemed a market maker in a debt security, the dealer must meet the legal requirements for market maker status, such as publishing quotes in the security.⁴

The proposed interpretation recognizes that a dealer may be required to look to other measures to correctly identify the prevailing market price of a security when the dealer has made no contemporaneous transactions or when inter-dealer transactions are rare or non-existent. The proposed guidance includes a non-exclusive list of five factors that a dealer may take into consideration in trying to establish prevailing market price using a measure other than the dealer's contemporaneous cost. These factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

1. Prices of any contemporaneous inter-dealer transactions in the security in question or prices of dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a “similar” security, as defined below;
2. Contemporaneous inter-dealer quotations or other indications of price (hereinafter, “quotations”) for the security in question made through an inter-dealer mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;
3. Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” securities;

⁴ See Section 3(a)(38) of the Act; 15 U.S.C. 78c(a)(38).

4. Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in the same or “similar” securities; and
5. Yields calculated from validated contemporaneous inter-dealer quotations in “similar” securities.

When applying the factors, the member 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 guidance, the relative importance of the factors depends on the facts and circumstances of the particular transaction. In addition, isolated transactions or isolated quotations generally will not have much, if any, weight or relevance.

Importantly, four of the five factors refer to “similar securities,” which is the second major concept proposed in the guidance and is discussed below.

“Similar Securities.”

The second fundamental issue addressed in the proposed interpretation is what is a “similar security” and when may a member consider it in determining the prevailing market price. The proposed interpretation provides guidance on using similar securities to determine the prevailing market price, which, as noted previously, is set forth in four of the five factors listed above. In addition, 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 security for which the mark-up is being calculated with another security. The non-exclusive list of factors that can be used to determine the degree to which a security is “similar” include 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;
- B. The extent to which the security trades at a comparable spread over Treasuries of similar duration;
- C. General structural characteristics 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; and
- D. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

These provisions, if adopted, would affirm specifically and explicitly for the members, for the first time, that at times, it may be appropriate to refer to “similar securities” to determine prevailing market price. In addition, the proposed interpretation provides guidance as to the degree of similarity that may be required.

The guidance regarding similar securities recognizes the special characteristics of debt instruments, and reflects the particular nature of trading in the debt markets, and if approved, would be incorporated specifically in NASD’s rules and interpretations for the first time. If adopted, the provisions would provide members additional flexibility in establishing the prevailing market price in those instances when a dealer does not believe that the dealer’s contemporaneous cost (or the dealer’s contemporaneous proceeds) is indicative of the prevailing market price.

In summary, NASD believes that the proposed interpretation provides important guidance to all members engaged in debt securities transactions on two issues. First, the guidance sets forth clearly in NASD's rules a basic principle, which is that a dealer's contemporaneous cost (or, when calculating a mark-down, the dealer's contemporaneous proceeds) is presumptively the prevailing market price. The proposed interpretation also provides guidance on when the principle may not be applicable, and, in those cases, how a dealer may correctly identify the prevailing market price of the subject security using measures other than the dealer's contemporaneous cost (or contemporaneous proceeds).

The second concept is that a dealer is explicitly 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.

(b) 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 clarifying the standard for correctly identifying the prevailing market price of a security for purposes of calculating a mark-up, clarifying the additional obligations of a member when it applies another

measure or standard, and confirming that similar securities may be used in certain instances in determining the prevailing market price are designed to prevent fraudulent practices, promote just and equitable principles of trade, and protect investors and the public interest.

4. 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.

5. 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.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: _____
Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

Date: September 16, 2003

EXHIBIT 1

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

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. 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 , 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. 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

NASD is proposing a second interpretation, proposed IM-2440-2, to Rule 2440. Proposed IM-2440-2 provides additional mark-up guidance for transactions in debt securities, except municipal securities. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

IM-2440-1. Mark-Up Policy

The question of fair mark-ups or spreads is one which has been raised from the earliest days of the Association. No definitive answer can be given and no interpretation can be all-inclusive for the obvious reason that what might be considered fair in one transaction could be unfair in another transaction because of different circumstances. In 1943, the Association's Board adopted what has become known as the "5% Policy" to be applied to transactions executed for customers. It was based upon studies demonstrating that the large majority of customer transactions were effected at a mark-up of 5% or less. The Policy has been reviewed by the Board of Governors on numerous occasions and each time the Board has reaffirmed the philosophy expressed in 1943. Pursuant thereto, and in accordance with Article VII, Section 1(a)(ii) of the By-Laws, the Board has adopted the following interpretation under Rule 2440.

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.

(a) through (d) No change.

IM-2440-2. Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities¹

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

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, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost or contemporaneous proceeds.

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* 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* or can show that in the particular circumstances the dealer's *contemporaneous proceeds* are not indicative of the prevailing market price.

When debt securities trade inactively, inter-dealer transactions may be rare or non-existent, and establishing the prevailing market price in a transaction involving an inactively traded debt security may be difficult.

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 must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost provides the best measure of the prevailing market price. In this respect, factors that NASD believes may be taken into consideration in establishing prevailing market price for a mark-up or a mark-down include, but are not limited to:

1. Prices of any contemporaneous inter-dealer transactions in the security in question or prices of dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a "similar" security, as defined below;

2. Contemporaneous inter-dealer quotations or other indications of price (hereinafter, “quotations”) for the security in question made through an inter-dealer mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;
3. Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
4. Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in the same or "similar" securities; and
5. Yields calculated from validated contemporaneous inter-dealer quotations in "similar" securities.

The relative importance of the factors listed above depends on the facts and circumstances surrounding the particular transaction, such as the order size, timeliness of the information, and the relative spread of the quotations. In addition, because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will not have much, if any, weight or relevance. For example, in considering yields of “similar” securities in Items 3, 4 and 5 above, 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.

A "similar" security should be sufficiently similar to the security under review 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 security under review 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.

The degree to which a security is "similar" as that term is used in Items 1, 3, 4, and 5 above, may be determined by factors that include but are not limited to:

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;

B. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

C. General structural characteristics 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; and

D. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

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.

¹. The interpretation does not apply to transactions in municipal securities. Statements regarding mark-ups also apply generally to mark-downs.

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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

(a) Purpose

Under Rule 2440, "Fair Prices and Commissions," members are required to sell securities to a customer at a fair price.³ 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. IM-2440, "Mark-Up

³ Rule 2440 specifically provides that a member is required to 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"

Policy,” provides additional guidance on mark-ups and fair pricing of securities transactions with customers.⁴

Under Rule 2440 and IM-2440, when a customer buys a security from the dealer, the customer’s total purchase price, and the mark-up included in the price, must be fair and reasonable. Similarly, when the 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 is fair and reasonable is correctly identifying the *prevailing market price* of the security, which is the basis from which the mark-up is calculated.

The proposed interpretation, “IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities,” provides additional guidance on mark-ups in debt securities transactions, except municipal securities transactions.⁵ 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 can it be considered in determining the prevailing market price.

Prevailing Market Price.

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 is presumptively the

⁴ 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.

⁵ Municipal Securities Rulemaking Board (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.”

dealer's contemporaneous cost (or contemporaneous proceeds). 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 or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price. 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 or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

The statement that a dealer's contemporaneous cost is presumptively the prevailing market price of a security is a restatement of a fundamental principle found in existing law in court cases and SEC and NASD decisions regarding mark-ups. The presumption that contemporaneous cost is the best evidence of prevailing market price is found in many cases, and, as early as 1992, its specific applicability to debt securities transactions was addressed by the SEC in F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993) ("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." F.B. Horner, 50 S.E.C. at 1065-1066. The basis for the standard was also restated. "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." F.B. Horner, 50 S.E.C. at 1066. The proposal contemplates that for a

dealer to be deemed a market maker in a debt security, the dealer must meet the legal requirements for market maker status, such as publishing quotes in the security.⁶

The proposed interpretation recognizes that a dealer may be required to look to other measures to correctly identify the prevailing market price of a security when the dealer has made no contemporaneous transactions or when inter-dealer transactions are rare or non-existent. The proposed guidance includes a non-exclusive list of five factors that a dealer may take into consideration in trying to establish prevailing market price using a measure other than the dealer's contemporaneous cost. These factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

1. Prices of any contemporaneous inter-dealer transactions in the security in question or prices of dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a "similar" security, as defined below;
2. Contemporaneous inter-dealer quotations or other indications of price (hereinafter, "quotations") for the security in question made through an inter-dealer mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;
3. Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;

⁶ See Section 3(a)(38) of the Act; 15 U.S.C. 78c(a)(38).

4. Yields calculated from prices of contemporaneous transactions with institutional accounts with which any dealer regularly effects transactions in the same or “similar” securities; and
5. Yields calculated from validated contemporaneous inter-dealer quotations in “similar” securities.

When applying the factors, the member 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 guidance, the relative importance of the factors depends on the facts and circumstances of the particular transaction. In addition, isolated transactions or isolated quotations generally will not have much, if any, weight or relevance.

Importantly, four of the five factors refer to “similar securities,” which is the second major concept proposed in the guidance and is discussed below.

“Similar Securities.”

The second fundamental issue addressed in the proposed interpretation is what is a “similar security” and when may a member consider it in determining the prevailing market price. The proposed interpretation provides guidance on using similar securities to determine the prevailing market price, which, as noted previously, is set forth in four of the five factors listed above. In addition, 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 security for which the mark-up is being calculated with another security. The non-exclusive list of factors that can be used to determine the degree to which a security is “similar” include 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;
- B. The extent to which the security trades at a comparable spread over Treasuries of similar duration;
- C. General structural characteristics 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; and
- D. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

These provisions, if adopted, would affirm specifically and explicitly for the members, for the first time, that at times, it may be appropriate to refer to “similar securities” to determine prevailing market price. In addition, the proposed interpretation provides guidance as to the degree of similarity that may be required.

The guidance regarding similar securities recognizes the special characteristics of debt instruments, and reflects the particular nature of trading in the debt markets, and if approved, would be incorporated specifically in NASD’s rules and interpretations for the first time. If adopted, the provisions would provide members additional flexibility in establishing the prevailing market price in those instances when a dealer does not believe that the dealer’s contemporaneous cost (or the dealer’s contemporaneous proceeds) is indicative of the prevailing market price.

In summary, NASD believes that the proposed interpretation provides important guidance to all members engaged in debt securities transactions on two issues. First, the guidance sets forth clearly in NASD's rules a basic principle, which is that a dealer's contemporaneous cost (or, when calculating a mark-down, the dealer's contemporaneous proceeds) is presumptively the prevailing market price. The proposed interpretation also provides guidance on when the principle may not be applicable, and, in those cases, how a dealer may correctly identify the prevailing market price of the subject security using measures other than the dealer's contemporaneous cost (or contemporaneous proceeds).

The second concept is that a dealer is explicitly 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.

(b) 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 clarifying the standard for correctly identifying the prevailing market price of a security for purposes of calculating a mark-up, clarifying the additional obligations of a member when it applies another

measure or standard, and confirming that similar securities may be used in certain instances in determining the prevailing market price are designed to prevent fraudulent practices, promote just and equitable principles of trade, and protect investors and the public interest.

(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.

Persons making written submissions should file six copies thereof with the Secretary, Securities

and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary