

June 29, 2004

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, Amendment No. 1
Additional Mark-Up Policy For Transactions in Debt Securities**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find Amendment No. 1 to SR-NASD-2003-141. NASD is proposing amendments to the proposed rule change to clarify certain provisions in proposed IM-2440 - 2, "Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities," ("Proposed Interpretation"), and to add more specific guidance for determining the prevailing market price when a dealer seeks to use other than its contemporaneous cost to calculate a mark-up.¹ Also, NASD is proposing corresponding amendments to the "purpose" section of the proposed rule change.²

Attached as Exhibit 1 is the notice of the proposed rule change prepared for the Federal Register that reflects the proposed amendments discussed below, and replaces, in its entirety, the Exhibit 1 filed on September 16, 2003. Also enclosed is a 3-1/2" disk containing the amended Exhibit 1 in Microsoft Word 7.0 to facilitate production of the Federal Register release. Exhibit 2, containing only the text of the Proposed Interpretation, is marked to show the changes from the Proposed Interpretation as filed on September 16, 2003 ("September 2003 Proposal") to this Amendment No. 1.

Amendments to Proposed Interpretation

For convenience, the proposed changes to IM-2440-2 are described as additions or deletions to the September 2003 Proposal, which contained nine paragraphs. In addition, there are three terms used in this Amendment No. 1: "subject security,"

¹ NASD is not proposing amendments to the guidance that is currently in place, IM-2440, "Mark-Up Policy," in this Amendment No. 1.

² The amendments to this section are found in Exhibit 1, II, "SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE," at (A)(a).

“subject transaction,” and “comparison transaction.” The term “subject security” means the security that is the subject of the transaction for which a mark-up or mark-down is being calculated. The term “subject transaction” means the transaction for which a mark-up or mark-down is being calculated. The term “comparison transaction” means a transaction, other than a transaction in the subject security, that one may look to in order to establish the prevailing market price for the subject transaction.

Paragraphs 1 through 4 of the September 2003 Proposal

NASD is not proposing to amend Paragraphs 1 through 3 of IM-2440-2.³ NASD is proposing to delete Paragraph 4 of the September 2003 Proposal, because it does not contain helpful guidance. (Paragraph 4 contains only one sentence, which is: “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.”)

Paragraph 5 of the September 2003 Proposal

NASD proposes to amend Paragraph 5 in several ways.⁴ The concepts in Paragraph 5 are expanded and addressed in more detailed provisions, such as requiring specific evidence in cases where certain large dealer-institutional transactions may be priced “away” from the prevailing market price due to the size and risk of the transaction. In addition, NASD assigns hierarchical value to certain types of evidence that have been recognized as important pricing benchmarks when establishing the prevailing market price of a security using a value other than the dealer’s contemporaneous cost (the “Hierarchy”). The proposed amendments describing the Hierarchy are set forth in new Paragraph 5A. Thereafter, NASD amends the list of five factors that may be used in certain circumstances to establish prevailing market price, deleting a factor and proposing minor amendments to the remaining four factors. These changes are set forth in new Paragraph 5B.

Paragraph 5 states that a dealer that effects a transaction with a customer and identifies the prevailing market price using a measure other than the dealer’s own contemporaneous cost or proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer’s contemporaneous cost or proceeds provide the best measure of the prevailing market price. NASD proposes to amend Paragraph 5 to add more specific guidance in certain circumstances where a dealer seeks to overcome

³ Paragraph 1 of the September 2003 Proposal begins with the words, “IM-2440-1 applies to debt securities” Paragraph 2 begins with the words, “A dealer that is acting” Paragraph 3 begins with the words, “When the dealer is *selling*”

⁴ Paragraph 5 of the September 2003 Proposal begins with the words, “A dealer that effects . . .” and ends with a list of five factors.

the presumption of contemporaneous cost or contemporaneous proceeds. NASD is proposing that a dealer must use a specific type of factual evidence, contemporaneous inter-dealer trades, when the dealer desires to overcome the presumption that contemporaneous cost or proceeds are the best measure of the prevailing market price when the dealer has engaged in a "Specified Institutional Trade." "Specified Institutional Trade" refers to certain dealer-institutional trades that the dealer asserts are priced away from the market due to the size and risk of the transaction. Amended Paragraph 5 reads as follows:

A dealer that effects a transaction in debt securities with a customer and identifies the prevailing market price using a measure other than the dealer's own contemporaneous cost or proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost or proceeds are not indicative of prevailing market price, and thus overcome the presumption, in instances such as where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined below, in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a "Specified Institutional Trade"). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In proposed Paragraph 5A, NASD identifies and assigns hierarchical value to three types of evidence -- inter-dealer transactions, certain dealer-institutional transactions, and certain quotations -- that may be used to establish the prevailing market price of a security. If a dealer has provided evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or proceeds) is the best measure of prevailing market price, these three benchmarks, if available, are the most important or persuasive evidence of a security's prevailing market price for the purpose of calculating a mark-up (mark-down). The first type of evidence, contemporaneous inter-dealer transactions in the subject security, is the most important pricing benchmark that should be taken into consideration in establishing prevailing market price. In the absence of

inter-dealer transactions, prices of contemporaneous dealer purchases (sales) in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security may be used in establishing the prevailing market price for mark-ups (mark-downs). In the absence of either of the above benchmarks, in an actively-traded security, a dealer must then look to certain quotations, if they are available. Proposed Paragraph 5A reads as follows:

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, such as where interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, the most important pricing benchmark that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, prices of contemporaneous dealer purchases (sales) in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security may be used in establishing the prevailing market prices for mark-ups (mark-downs) to customers. For actively traded securities, contemporaneous bid (offer) quotations for the security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations, may be used in the absence of inter-dealer or institutional transactions in determining prevailing market price for customer mark-ups (mark-downs).

This Hierarchy reflects SEC policy that has been in place since at least 1987 regarding the identification of the prevailing market price in debt securities transactions.⁵

Proposed Paragraph 5B contains an amended list of factors, which were previously set forth as five enumerated factors in Paragraph 5 of the September 2003 Proposal. As proposed herein, the factors are of less evidentiary value than the Hierarchy set forth in Paragraph 5A above, and, in contrast to the Hierarchy, are not listed in any order of evidentiary weight or importance.⁶ In addition, there are only four factors in this Amendment No. 1 because the use of pricing from inter-dealer transactions in the same security is proposed as part of the Hierarchy in Paragraph 5A, rather than one of the less important factors in Paragraph 5B. Proposed Paragraph 5B provides:

⁵ See Securities Exchange Act Release No. 24368 (April 21, 1987) 52 FR 15575 (April 29, 1987), 1987 SEC LEXIS 2005, *7 (SEC release on zero coupon securities).

⁶ Because the factors are not listed in order of importance, NASD proposes to delete the numbering.

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

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

Paragraph 6 of the September 2003 Proposal

NASD proposes to amend the first sentence in Paragraph 6 and to create a new Paragraph 6A.⁷ In the September 2003 Proposal, NASD proposed the following: “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.”⁸ The proposed amendment to the sentence clarifies that the relative weight one may attribute to pricing information derived from a transaction in a similar security depends, in part, upon whether the comparison transaction is comparable or similar to the subject transaction (e.g., are the sizes of the subject transaction comparable to the comparison transaction, how close in time are the comparison and subject transactions, etc.). The amended sentence then provides specific examples of how certain facts or circumstances applicable to each transaction may result

⁷ Paragraph 6 of the September 2003 Proposal begins with the words, “The relative importance”

⁸ The phrase, “factors listed above” refers to the factors formerly in proposed Paragraph 5 and now in proposed Paragraph 5B.

in two transactions being sufficiently similar such that a dealer may refer to the values in the comparison transaction (e.g., price or yield) to aid the dealer in determining the prevailing market price of the subject security in the subject transaction. NASD proposes to amend Paragraph 6 to read:

The relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the similar security to the quotations in the subject security.

In addition, NASD proposes to move the last two sentences of Paragraph 6 to make a new Paragraph 6A and to make minor technical changes to the sentences. Proposed Paragraph 6A provides:

Because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price. For example, in considering yields of “similar” securities, except in extraordinary circumstances, members may not rely exclusively on isolated transactions or a limited number of transactions that are not fairly representative of the yields of transactions in “similar” securities taken as a whole.

Paragraphs 7 through 9 of the September 2003 Proposal

Paragraphs 7 through 9 discuss the use of “similar” securities in determining the prevailing market price of a security.⁹ Paragraph 7 describes a “similar” security in general terms. Paragraph 8 lists factors A through D that may be used to determine the degree to which a security is “similar” to the subject security. In Paragraph 9, NASD identifies circumstances when the prevailing market price may not be identified by referencing another, “similar” security because there may be no security that is sufficiently “similar” to the subject security.

NASD is proposing minor amendments to Paragraph 8, and no changes to Paragraph 7 and Paragraph 9. In Paragraph 8, NASD proposes to delete references in the first line, to “Items 1, 3, 4 and 5,” which refer to the numbering that was deleted in proposed Paragraph 5B. In addition, NASD proposes to make minor technical changes to

⁹ Paragraph 7 begins with the words, “A ‘similar’ security” Paragraph 8 begins with the words, “The degree to which” Paragraph 9, the last paragraph, begins with the words, “When a debt security’s value”

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the four factors that set forth characteristics one may use to determine the similarity between the subject and another security by adding a reference to the subject security in each factor. Finally, NASD proposes to delete two items, size of issue and comparability of quotations, from the fourth bullet, which contains technical factors that one may consider to determine similarity between securities. Both “technical factors” are already set forth in a previous paragraph in the Proposed Interpretation regarding whether transactions (or quotation spreads) are sufficiently comparable to be used to determine prevailing market price for the subject transaction in the subject security. NASD also proposes to make minor technical changes to Footnote 1 in IM-2440-2.

Other Proposed Amendments

NASD is also proposing amendments to the section of the proposed rule change in which the purpose and explanatory text are set forth. The amended “purpose” section is set forth in attached Exhibit 1. The proposed amendments to the “purpose” section describe the amendments that NASD is proposing herein to the text of IM-2440-2.

If you have any questions, please contact Sharon K. Zackula, Associate 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: Exhibit 1
Exhibit 2

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 Guidance 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 September 16, 2003, 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 , NASD filed Amendment No. 1 to the proposed rule change.³ 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.

³ See letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Katharine A. England, Assistant Director, Division of Market Regulation, SEC, dated June 29, 2004, and enclosures (“Amendment No. 1”).

* * * * *

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.

A dealer that effects a transaction in debt securities with a customer and identifies the prevailing market price using a measure other than the dealer's own contemporaneous cost or proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost or proceeds are not indicative of prevailing market price, and thus overcome the presumption, in instances such as where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade with an institutional account with which the dealer

regularly effects transactions in the same or a “similar” security, as defined below, in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a “Specified Institutional Trade”). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer’s contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer’s Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer’s contemporaneous cost or proceeds provide the best measure of the prevailing market price, such as where interest rates or the credit quality of the security changed significantly after the dealer’s contemporaneous trades, the most important pricing benchmark that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, prices of contemporaneous dealer purchases (sales) in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security may be used in establishing the prevailing market prices for mark-ups (mark-downs) to customers. For actively traded securities, contemporaneous bid (offer) quotations for the

security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations, may be used in the absence of inter-dealer or institutional transactions in determining prevailing market price for customer mark-ups (mark-downs).

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

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

The relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the similar security to the quotations in the subject security.

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

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 this Interpretation, to the subject security 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 as the subject security;

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

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, as compared with the characteristics of the subject security; and

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

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. The singular and plural forms of the terms, "(sale)," "(mark-down)," and "(offer)," refer to factors members will use to calculate or charge a customer a mark-down.

* * * * *

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.⁴ 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 Policy,” provides additional guidance on mark-ups and fair pricing of securities transactions with customers.⁵

⁴ 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” Rule 2320, “Best Execution and Interpositioning,” also addresses a member’s obligation in pricing customer transactions. In any transaction for or with a customer, Rule 2320 requires a member to “use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy and sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.” Together, Rule 2440 and Rule 2320 impose broad responsibilities on broker-dealers to price customer transactions fairly. Cf. “Review of Dealer Pricing Responsibilities,” MSRB Notice 2004 – 3 (January 26, 2004).

⁵ 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.

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

The proposed interpretation, "IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities" ("Proposed Interpretation"), provides additional guidance on mark-ups (mark-downs) in debt securities transactions, except municipal securities transactions.⁶ 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

⁶ 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."

presumptively the dealer's contemporaneous cost (proceeds).⁷ 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

⁷ Of course, if a dealer violates Rule 2320, the dealer's contemporaneous cost (proceeds) in such transactions would not be a reliable indicator of the prevailing market price for the purpose of determining a mark-up or mark-down. If a dealer violates Rule 2320 because the dealer fails to exercise diligence, fails to negotiate at arms length in the market, or engages in fraudulent transactions, including those entered into in collusion with other dealers or brokers, including inter-dealer brokers, the price that the dealer obtains is not a price reflecting market forces, and, therefore, is not a valid indicator of the prevailing market price and should not be used to calculate a mark-up (mark-down). In addition, if a dealer that is not a party to a transaction engages in conduct to improperly influence the pricing of such transaction, the dealer could not properly use the execution price as the basis from which to compute a mark-up (mark-down) because the execution price does not represent the prevailing market price of the security.

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, as provided in Section 3(a)(38) of the Act.⁸

The Proposed Interpretation sets forth a two-step process for using a measure other than the dealer's own contemporaneous cost (proceeds) as the prevailing market price in determining a mark-up (mark-down). First, the Proposed Interpretation recognizes that in some circumstances, a dealer may seek to overcome the presumption and discusses three examples where the facts and circumstances may provide the basis, in some cases, for overcoming the presumption. Second, when a dealer overcomes the presumption, the dealer must be prepared to provide evidence of the appropriate measure of the prevailing market price.

The Proposed Interpretation cites three circumstances where a dealer may be able to show that its contemporaneous cost or proceeds are not indicative of the prevailing market price—when interest rates change significantly or the credit quality of the subject security changes significantly after the dealer's contemporaneous trades, or where the dealer's contemporaneous trade with an institutional account with which the dealer

⁸ 15 U.S.C. 78c(a)(38).

regularly effects transactions in the same or a "similar" security, in a sale to or a purchase from such institution, was executed away from the prevailing market due to the size and risk of the transaction. In the Proposed Interpretation, this type of trade is defined as a "Specified Institutional Trade."

When a dealer has executed a Specified Institutional Trade contemporaneously with the subject transaction and seeks to overcome the presumption that the Specified Institutional Trade provides the best evidence of the prevailing market price (i.e., the dealer's contemporaneous cost in the case of a mark-up, or the dealer's contemporaneous proceeds in the case of a mark-down), NASD proposes that the dealer must provide specific evidence of the then prevailing market price to overcome the presumption that the dealer's cost in the Specified Institutional Transaction (in the case of a mark-up in the subject transaction), or the dealer's proceeds in the Specified Institutional Trade (in the case of a mark-down in the subject transaction) are not the best evidence of prevailing market price. The specific evidence that the dealer is required to provide is pricing information from inter-dealer transactions in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the presumption has been overcome, such as where interest rates or credit quality of the security changed significantly, the Proposed Interpretation sets forth a hierarchy of three benchmarks or measures that the dealer is required to look to, in the order that they are presented, to establish prevailing market price (the "Hierarchy"). The most important benchmark in the Hierarchy is the pricing of any contemporaneous inter-dealer

transactions in the same security. The second most important benchmark in the Hierarchy recognizes the role of certain large institutions in the fixed income securities markets. In the absence of inter-dealer transactions, the second benchmark a dealer must consider is “prices of contemporaneous dealer purchases (sales), in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security.” (Contemporaneous dealer sales with such institutional accounts would be used to calculate a mark-down.)⁹ If contemporaneous inter-dealer trades or dealer-institutional trades in the same security are not available, a dealer must look to the third benchmark in the Hierarchy, which may be applied only to actively-traded securities. For actively traded securities, a dealer is required to look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if such quotations are made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.¹⁰

If none of the three benchmarks in the Hierarchy is available, the Proposed Interpretation includes a non-exclusive list of four 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 (proceeds). These factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

⁹ If a dealer has overcome the presumption by establishing that interest rates or the credit quality of the security changed significantly after the dealer’s trade, any inter dealer or dealer-institutional trades in the same security *that occurred prior to the event* would not be valid measures of the prevailing market price as such transactions would be subject to the same imperfection.

¹⁰ A dealer is subject to the two-step process, including the analysis under the Hierarchy and the other factors discussed below in determining prevailing market price, where a dealer overcomes the presumption of contemporaneous cost (proceeds) by establishing that the dealer has not

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

When applying 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 Interpretation, the relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer in the subject transaction, the timeliness of the information, and, with respect to the final factor, the relative spread of the quotations in the “similar” security to the quotations in the subject security. In addition, isolated

engaged in trading in the subject security for an extended period and has no contemporaneous cost

transactions or isolated quotations generally will not have much, if any, weight or relevance in establishing the prevailing market price.

Importantly, each of the four factors refers 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. In the four factors set forth above, the Proposed Interpretation provides guidance on using “similar” securities to determine the prevailing market price. To aid members in identifying “similar” securities when appropriate, the final part of 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 (i.e., the subject security) with another security. The non-exclusive list of factors that can be used to determine the degree to which a security is “similar” to the subject security 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 as the subject security;
- B. The extent to which the spread (i.e., the spread over U.S. Treasury securities of a similar duration) at which the security trades is comparable to the spread at which the subject security trades;

(proceeds) to refer to as a basis for computing a mark-up (mark-down).

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

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. If adopted, the provisions would provide members additional flexibility in establishing the prevailing market price in those instances when a dealer seeks to overcome the presumption 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, guidance on the dealer's obligation to provide evidence of the prevailing market price using the benchmarks and factors set forth above, and, as applicable, in the priority set forth above, and any other relevant evidence of prevailing market price.

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. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2003-141. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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

EXHIBIT 2

Exhibit 2 is marked to show changes proposed to IM-2440-2 from the September 2003 Proposal to this Amendment No. 1. New text is underlined and deleted text is 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 or proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous

cost or proceeds are not indicative of prevailing market price, and thus overcome the presumption, in instances such as where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined below, in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a "Specified Institutional Trade"). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, such as where interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, the most important pricing benchmark that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, prices of

contemporaneous dealer purchases (sales) in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security may be used in establishing the prevailing market prices for mark-ups (mark-downs) to customers. For actively traded securities, contemporaneous bid (offer) quotations for the security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations, may be used in the absence of inter-dealer or institutional transactions in determining prevailing market price for customer mark-ups (mark-downs).

[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:]

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

[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;]

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

The relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the final

factor listed above, the relative spread of the quotations in the similar security to the quotations in the subject security.[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]Because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will have little or no[will not have much, if any,] weight or relevance in establishing prevailing market price. 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 this Interpretation[Items 1, 3, 4, and 5 above], to the subject security 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 as the subject security;

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

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. The singular and plural forms of the terms, "(sale)," "(mark-down)," and "(offer)," refer to factors members will use to calculate or charge a customer a mark-down. [Statements regarding mark-ups also apply generally to mark-downs.]