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May 11, 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-2004-026 – Proposed Amendments to Rule 2320(a),
NASD’s Best Execution Rule; Amendment No. 1**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. This rule filing replaces and supersedes in its entirety the original rule filing filed with the Securities and Exchange Commission on February 11, 2004. 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 Kathleen A. O’Mara, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8056; e-mail kathleen.omara@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-2004-026
Amendment No. 1
Consists of 53 Pages
May 11, 2004

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 amend NASD Rule 2320(a) (“Best Execution Rule”). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

2320. Best Execution and Interpositioning

(a)(1) In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

[(1)](A) [T]the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

[(2)](B) the size and type of transaction;

[(3)](C) the number of primary markets checked;

[(4)](D) the location and accessibility to the customer’s broker/dealer of primary markets and quotations sources[.]; and

(E) with respect to customer orders that are routed to another broker/dealer for handling and/or execution, the existence of a written agreement or written representation that the customer will receive best execution.

(2) For purposes of subparagraph (a)(1) only, the term “customer” also shall include a customer of a broker/dealer that originates an order on behalf of the customer (the “originating broker/dealer”) and directs it to a member (the “recipient member”), provided there is a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that the recipient member and persons associated with the recipient member will provide best execution to such order in conformity with subparagraph (a)(1). Nothing in this subparagraph (a)(2) changes the originating broker/dealer’s obligation to comply with subparagraph (a)(1) with respect to such order.

(b) through (g) No change.

* * * * *

(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 November 12, 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 reviewed the proposed rule change at its meeting on November 13, 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 amendments to 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 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Kathleen A. O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8056.

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

(a) Purpose

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term "customer," in the context of best execution. NASD Rule 0120(g) defines "customer" as not including a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an

order from a customer (“originating broker/dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could attempt to maintain that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker/dealer.

NASD believes that not applying the Best Execution Rule to recipient members may be contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker/dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice.¹ The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.

Proposal

NASD is proposing to amend the Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that it will provide best execution to

¹ Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on

the originating broker/dealer's customer orders. The proposed rule change also would clarify that the originating broker/dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists. Accordingly, an originating broker/dealer member must ensure its best execution obligations to its customers are met, and it cannot rely on a written agreement or written representation as a safe harbor.²

NASD believes that the proposed rule change will provide better clarity to members and will establish a fair standard that explicitly extends best execution requirements to recipient members under specific circumstances.³ Further, NASD believes that the proposed rule change will enhance NASD's ability to pursue actions for failure to provide best execution where a recipient member has not provided best execution as expressly agreed to or represented in writing.⁴

As noted above, an originating broker/dealer that is a member remains obligated to comply with the Best Execution Rule, even where a recipient broker/dealer (without

Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

² In this respect, an originating broker/dealer member would remain obligated to conduct a regular and rigorous review of the execution quality of orders routed to recipient broker/dealers with which it has a written agreement or has received representations as to the provision of best execution.

³ In Notice to Members 97-57 (September 1997), NASD stated that a market maker that has undertaken expressly or implicitly to provide best execution to the customer orders of another broker/dealer pursuant to an arrangement or understanding must, in fact, provide such orders best execution. In addition, NASD identified specific circumstances that would give rise to a duty of best execution. Where applicable, the proposed rule change would modify the circumstances set forth in that Notice. For example, an implicit arrangement to provide best execution will not be inferred when an originating broker/dealer and a recipient member enter into a payment for order flow, reciprocal, or correspondent arrangement. In general, a written agreement or written representation would be needed to give rise to a recipient member's duty of best execution under Rule 2320.

regard to whether the recipient broker/dealer is a member) has agreed to provide best execution for orders routed to it. As such, the proposed rule change does not alter the obligation of an originating broker/dealer member to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. NASD, however, expects that the existence of a written agreement or representation from a recipient broker/dealer that it will provide best execution will be a significant factor in determining whether the originating broker/dealer member has met its best execution obligations when routing customer orders. In addition, there is a strong presumption that, as part of its Rule 2320 best execution obligations, an originating broker/dealer member must seek to obtain a written agreement that expressly states that the recipient broker/dealer will provide the originating broker/dealer's customers with best execution when the originating broker/dealer member has discretion to route the customers' order flow to a recipient broker/dealer (i.e., non-directed orders) and does so on a regular basis.⁵ Moreover, in instances when a customer directs that its order be routed to and executed by a specific recipient broker/dealer (i.e., directed orders), the originating broker-dealer member should disclose whether it has a written agreement with, or representation from, the recipient broker/dealer to provide best execution to the customer's order or, in the absence of such written agreement or representation, disclose

⁴ In egregious situations, NASD staff may bring an action against the recipient member under Rule 2120, Use of Manipulative, Deceptive or Other Fraudulent Devices, even if no written agreement or representation were provided.

⁵ See Notice to Members 01-22 (April 2001), that reiterates the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and that also provides guidance to members concerning a broker/dealer's obligation, as articulated on numerous occasions by the SEC, to examine regularly and rigorously execution quality likely to be obtained from the different markets or market makers trading a security.

that by directing the order to a specific recipient broker/dealer the customer's order may not receive best execution.

In cases where the obligations specified in Rule 2320(a)(2) are triggered by a recipient member's written representation that it will provide best execution to customer orders routed to the recipient member by the originating broker/dealer, NASD staff envisions that such representations may arise in a variety of forms. For example, such written representations could be distributed by the recipient member via its Web site, promotional literature, or in its advertising.⁶ Moreover, where any such representations by a recipient member do not specify a definite term for which the recipient member will provide best execution, the recipient member will be responsible for providing best execution unless specifically revoked in writing. In addition, an originating broker/dealer member will need to verify periodically that any representation as to best execution from recipient broker/dealers remain in effect.

NASD staff believes that it would be inappropriate for an originating broker/dealer to rely upon a negative consent letter as an agreement or a representation by a recipient broker/dealer that the recipient broker/dealer would provide best execution with respect to routed order flow. Accordingly, a negative consent letter would not be considered a written agreement or representation under Rule 2320(a)(2).

NASD members will be required to retain copies of all written agreements and written representations that trigger obligations under Rule 2320. Pursuant to Rule 3110(a), written agreements are considered member records and, therefore, must be

⁶ Depending upon the delivery method of the written representation, members should be aware of the possible need to comply with the provisions set forth in Rule 2210 "Communications with the Public" and Rule 2211 "Institutional Sales Material and Correspondence."

preserved by both the recipient member and originating broker/dealer member. In addition, originating broker/dealer members and recipient members must preserve any written representation regarding best execution that constitutes “communications” under Exchange Act Rule 17a-4.⁷

NASD also is amending subparagraph (a)(1) of the Best Execution Rule to clarify that the existence of a written agreement or written representation will be examined as a factor in determining whether an originating broker/dealer member has used “reasonable diligence” when a customer order is routed by the originating broker/dealer member to a recipient broker/dealer for handling or execution. In addition, the existence of a written agreement or written representation also will be examined when determining whether the recipient member has fulfilled its obligations.

Furthermore, NASD is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule currently requires a member to ascertain the best “inter-dealer” market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. As a result of changes in market structure, including the recent expansion of trading in Nasdaq securities to national securities exchanges, NASD is proposing to delete the term “inter-dealer” from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may

⁷ Exchange Act Rule 17a-4(4) generally requires that originals of all communications received and copies of all communications sent by the member, broker or dealer relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public be preserved.

include all market centers in which a security is traded.⁸

Upon SEC approval of this rule proposal, NASD will notify members of the amendments and issue interpretive guidance consistent with the interpretive positions specified in this rule filing in a Notice to Members.

(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 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. The obligation of a member firm to provide best execution to its customers' orders has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will provide better clarity to members and will enhance NASD's ability, under specific circumstances, to pursue actions for failure to provide best execution.

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

⁸ Originating broker/dealer members would remain obligated to conduct a regular and rigorous review of the execution quality of orders routed to market centers regardless of whether there is a written agreement or representation.

As discussed in the Purpose section above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another broker/dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) limited to customer orders where there is an agreement or arrangement between the two broker/dealers that the recipient broker/dealer would comply with the duty of best execution; (2) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customer orders or there is another arrangement between the two broker/dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker/dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker/dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited comment on whether the Best Execution Rule should distinguish, if at all, between customer orders received by a member from a foreign affiliate or foreign broker/dealer (as opposed to customer orders received by a member from a domestic affiliate or domestic broker/dealer that is subject to SEC, NASD, or other legal obligations concerning best execution).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.⁹ Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker/dealer as customer orders. Lastly, similar to the approach in the proposed rule change, two commenters articulated that the receiving broker/dealer should only have a duty of best execution under Rule 2320 when the receiving broker/dealer has explicitly agreed to handle orders received from the originating broker/dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.¹⁰ In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests.

After considering the comments received in response to the Notice, NASD is

⁹ See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

¹⁰ See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

proposing to amend the Best Execution Rule as discussed herein.

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.
2. NASD Notice to Members 02-40 (July 2002).
3. Comments received in response to NASD Notice to Members 02-40 (July 2002).

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: May 11, 2004

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2004-026)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend NASD's Best Execution Rule

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 and Amendment 1³ 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 to amend Rule 2320(a) ("Best Execution Rule"). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

2320. Best Execution and Interpositioning

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

³ This 19b-4 filing represents Amendment No. 1 and replaces and supercedes in its entirety the original rule filing.

(a)(1) In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

[(1)](A) [T]the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

[(2)](B) the size and type of transaction;

[(3)](C) the number of primary markets checked;

[(4)](D) the location and accessibility to the customer’s broker/dealer of primary markets and quotations sources[.]; and

(E) with respect to customer orders that are routed to another broker/dealer for handling and/or execution, the existence of a written agreement or written representation that the customer will receive best execution.

(2) For purposes of subparagraph (a)(1) only, the term “customer” also shall include a customer of a broker/dealer that originates an order on behalf of the customer (the “originating broker/dealer”) and directs it to a member (the “recipient member”), provided there is a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that the recipient member and persons associated with the recipient member will provide best execution to such order in conformity with

subparagraph (a)(1). Nothing in this subparagraph (a)(2) changes the originating broker/dealer's obligation to comply with subparagraph (a)(1) with respect to such order.

(b) through (g) No change.

* * * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

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

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

(1) Purpose

Background

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

(“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could attempt to maintain that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker/dealer.

NASD believes that not applying the Best Execution Rule to recipient members may be contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker/dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice.⁴ The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.

Proposal

NASD is proposing to amend the Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that it will provide best execution to the originating broker/dealer’s customer orders. The proposed rule change also would

⁴ Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on

clarify that the originating broker/dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists. Accordingly, an originating broker/dealer member must ensure its best execution obligations to its customers are met, and it cannot rely on a written agreement or written representation as a safe harbor.⁵

NASD believes that the proposed rule change will provide better clarity to members and will establish a fair standard that explicitly extends best execution requirements to recipient members under specific circumstances.⁶ Further, NASD believes that the proposed rule change will enhance NASD's ability to pursue actions for failure to provide best execution where a recipient member has not provided best execution as expressly agreed to or represented in writing.⁷

As noted above, an originating broker/dealer that is a member remains obligated to comply with the Best Execution Rule, even where a recipient broker/dealer (without regard to whether the recipient broker/dealer is a member) has agreed to provide best

Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

⁵ In this respect, an originating broker/dealer member would remain obligated to conduct a regular and rigorous review of the execution quality of orders routed to recipient broker/dealers with which it has a written agreement or has received representations as to the provision of best execution.

⁶ In Notice to Members 97-57 (September 1997), NASD stated that a market maker that has undertaken expressly or implicitly to provide best execution to the customer orders of another broker/dealer pursuant to an arrangement or understanding must, in fact, provide such orders best execution. In addition, NASD identified specific circumstances that would give rise to a duty of best execution. Where applicable, the proposed rule change would modify the circumstances set forth in that Notice. For example, an implicit arrangement to provide best execution will not be inferred when an originating broker/dealer and a recipient member enter into a payment for order flow, reciprocal, or correspondent arrangement. In general, a written agreement or written representation would be needed to give rise to a recipient member's duty of best execution under Rule 2320.

execution for orders routed to it. As such, the proposed rule change does not alter the obligation of an originating broker/dealer member to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. NASD, however, expects that the existence of a written agreement or representation from a recipient broker/dealer that it will provide best execution will be a significant factor in determining whether the originating broker/dealer member has met its best execution obligations when routing customer orders. In addition, there is a strong presumption that, as part of its Rule 2320 best execution obligations, an originating broker/dealer member must seek to obtain a written agreement that expressly states that the recipient broker/dealer will provide the originating broker/dealer's customers with best execution when the originating broker/dealer member has discretion to route the customers' order flow to a recipient broker/dealer (i.e., non-directed orders) and does so on a regular basis.⁸ Moreover, in instances when a customer directs that its order be routed to and executed by a specific recipient broker/dealer (i.e., directed orders), the originating broker-dealer member should disclose whether it has a written agreement with, or representation from, the recipient broker/dealer to provide best execution to the customer's order or, in the absence of such written agreement or representation, disclose that by directing the order to a specific recipient broker/dealer the customer's order may not receive best execution.

⁷ In egregious situations, NASD staff may bring an action against the recipient member under Rule 2120, Use of Manipulative, Deceptive or Other Fraudulent Devices, even if no written agreement or representation were provided.

⁸ See Notice to Members 01-22 (April 2001), that reiterates the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and that also provides guidance to members concerning a broker/dealer's obligation, as articulated

In cases where the obligations specified in Rule 2320(a)(2) are triggered by a recipient member's written representation that it will provide best execution to customer orders routed to the recipient member by the originating broker/dealer, NASD staff envisions that such representations may arise in a variety of forms. For example, such written representations could be distributed by the recipient member via its Web site, promotional literature, or in its advertising.⁹ Moreover, where any such representations by a recipient member do not specify a definite term for which the recipient member will provide best execution, the recipient member will be responsible for providing best execution unless specifically revoked in writing. In addition, an originating broker/dealer member will need to verify periodically that any representation as to best execution from recipient broker/dealers remain in effect.

NASD staff believes that it would be inappropriate for an originating broker/dealer to rely upon a negative consent letter as an agreement or a representation by a recipient broker/dealer that the recipient broker/dealer would provide best execution with respect to routed order flow. Accordingly, a negative consent letter would not be considered a written agreement or representation under Rule 2320(a)(2).

NASD members will be required to retain copies of all written agreements and written representations that trigger obligations under Rule 2320. Pursuant to Rule 3110(a), written agreements are considered member records and, therefore, must be preserved by both the recipient member and originating broker/dealer member. In addition, originating broker/dealer members and recipient members must preserve any

on numerous occasions by the SEC, to examine regularly and rigorously execution quality likely to be obtained from the different markets or market makers trading a security.

written representation regarding best execution that constitutes “communications” under Exchange Act Rule 17a-4.¹⁰

NASD also is amending subparagraph (a)(1) of the Best Execution Rule to clarify that the existence of a written agreement or written representation will be examined as a factor in determining whether an originating broker/dealer member has used “reasonable diligence” when a customer order is routed by the originating broker/dealer member to a recipient broker/dealer for handling or execution. In addition, the existence of a written agreement or written representation also will be examined when determining whether the recipient member has fulfilled its obligations.

Furthermore, NASD is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule currently requires a member to ascertain the best “inter-dealer” market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. As a result of changes in market structure, including the recent expansion of trading in Nasdaq securities to national securities exchanges, NASD is proposing to delete the term “inter-dealer” from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may

⁹ Depending upon the delivery method of the written representation, members should be aware of the possible need to comply with the provisions set forth in Rule 2210 “Communications with the Public” and Rule 2211 “Institutional Sales Material and Correspondence.”

¹⁰ Exchange Act Rule 17a-4(4) generally requires that originals of all communications received and copies of all communications sent by the member, broker or dealer relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public be preserved.

include all market centers in which a security is traded.¹¹

Upon SEC approval of this rule proposal, NASD will notify members of the amendments and issue interpretive guidance consistent with the interpretive positions specified in this rule filing in a Notice to Members.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD 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. The obligation of a member firm to provide best execution to its customers' orders has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will provide better clarity to members and will enhance NASD's ability, under specific circumstances, to pursue actions for failure to provide best execution.

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

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

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

¹¹ Originating broker/dealer members would remain obligated to conduct a regular and rigorous review of the execution quality of orders routed to market centers regardless of whether there is a written agreement or representation.

As discussed in the Purpose section above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another broker/dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) limited to customer orders where there is an agreement or arrangement between the two broker/dealers that the recipient broker/dealer would comply with the duty of best execution; (2) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customer orders or there is another arrangement between the two broker/dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker/dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker/dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited comment on whether the Best Execution Rule should distinguish, if at all, between customer orders received by a member from a foreign affiliate or foreign broker/dealer (as opposed to customer orders received by a member from a domestic affiliate or domestic broker/dealer that is subject to SEC, NASD, or other legal obligations concerning best execution).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.¹² Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker/dealer as customer orders. Lastly, similar to the approach in the proposed rule change, two commenters articulated that the receiving broker/dealer should only have a duty of best execution under Rule 2320 when the receiving broker/dealer has explicitly agreed to handle orders received from the originating broker/dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.¹³ In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests.

After considering the comments received in response to the Notice, NASD is

¹² See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

¹³ See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

proposing to amend the Best Execution Rule as discussed herein.

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 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-2004-026. 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