Notice to Members

JULY 2002

SUGGESTED ROUTING

Legal & Compliance
Market Making
Operations
Registered Representatives
Senior Management
Trading

KEY TOPICS

Best Execution

REQUEST FOR COMMENT **ACTION REQUESTED BY AUGUST 9, 2002**

Best Execution

NASD Requests Comment On Proposed Amendments to NASD Rule 2320 (Best Execution Rule); **Comment Period Expires on August 9, 2002**

Executive Summary

NASD requests comment from members, investors, and other interested parties on proposed amendments to NASD Rule 2320(a) (the "Best Execution Rule").[1] If adopted, these amendments would clarify the scope of the duty of best execution in circumstances where a broker/dealer receives, for execution, a customer order from another broker/dealer.

Specifically, NASD seeks comment on whether the scope of the duty of best execution, as codified in NASD Rule 2320, should be clarified to include customer orders received by a member from another broker/dealer and, if so, whether the scope of the duty should: (1) be 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) be limited to customer orders routed pursuant to an arrangement or an agreement noted in *Notice to Members 97-57* (*i.e.*, where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customers' orders or there is another arrangement between the two broker/dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) be limited to customer orders routed pursuant to an arrangement or an agreement (including, but not limited to, those noted in *Notice to Members 97-57*) where the recipient broker/dealer assesses a fee or charge to execute the order; (4) be defined more broadly to include all orders that are identified by the routing member as customer orders; and/or (5) clarified or amended in some other fashion. NASD also seeks 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).

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Questions/Further Information

Questions concerning this *Notice* may be directed to Kathleen O'Mara, Assistant General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8071; or Peter D. Santori, Assistant Chief Counsel, Market Regulation Department, NASD Regulatory Policy and Oversight, at (240) 386-5126.

Request for Comment

NASD requests comment on the proposed amendments to Rule 2320 described herein. Comments must be received by August 9, 2002. Members and interested persons can submit their comments using the following methods:

- mailing in written comments
- e-mailing written comments to *pubcom@nasd.com*
- submitting comments online on NASD Web Site (*www.nasd.com*)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted by mail, e-mail, or to the NASD Web Site.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must by approved by the Securities and Exchange Commission.

Background and Discussion

The obligation of a member 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. The Best Execution Rule 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 Rule 0120(g), however, defines "customer" as not including a broker or dealer, unless the context otherwise requires. NASD staff has received a number of questions regarding the application of the term "customer," as that term is defined in Rule 0120(g), to the Best Execution Rule. For example, if a broker/dealer routes an order that it receives from a customer to a market maker in the subject security, and that order is executed in a manner otherwise inconsistent with the Best Execution Rule, some members have maintained that the executing market maker has not violated the Best Execution Rule, strictly on the basis that the transaction was not "for or with a customer," but rather for or with a broker/dealer. NASD views this argument as contrary to the interests of the investing public as well as the intent of the Best Execution Rule and notes that, if such an argument were sustained, a sizeable portion of transactions that take place in the over-the-counter market that involve routed customer orders would be executed without the benefit of the protections of the duty of best execution. Furthermore, NASD believes that it would be fundamentally unfair if the applicability of the Best Execution Rule depended on whether a customer order was routed to another broker/dealer for execution (as opposed to being executed internally).

In its release adopting the Order Handling Rules, SEC Rules 11Ac1-1(c)(5) and 11Ac1-4, the Securities and Exchange Commission (SEC) made specific statements concerning the duty of best execution. Specifically, the SEC stated that when a market maker holds an undisplayed customer limit order priced better than its public quote, and it subsequently receives a customer market order on the opposite side of the market from the limit order, it is no longer appropriate for the market maker to execute both orders as principal rather than crossing the two orders at the same price.[2] Instead, the market maker is required to pass along the price improvement offered by the limit order to the market order (hereinafter, "the crossing obligation").[3] In *Notice to Members 97-57* (September 1997), The Nasdaq Stock Market, Inc., and NASD, in consultation with the SEC, answered a number of questions regarding the obligation of members to obtain best execution of customer orders in light of this requirement. In that *Notice*, Nasdaq and NASD set forth the types of relationships pursuant to which market makers would be required to satisfy the crossing obligation specifically and, by extension, the duty of best execution generally. Specifically, Nasdaq and 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.[4] In this regard, Nasdaq and NASD identified specific circumstances that would give rise to a duty of best execution, such as where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customers' orders or there is another arrangement between the two broker/dealers (such as a payment for order flow, reciprocal, or correspondent arrangement).[5]

Since the guidance provided in *Notice to Members 97-57*, developments to the market have changed the types of relationships, arrangements, and understandings that normally accompany order routing and order flow decisions. For example, decimalization and other competitive forces have reduced dramatically the level of customer order flow that is directed from one broker/dealer to another pursuant to payment for order flow or reciprocal order routing arrangements. In fact, in some cases market makers that formerly paid for order flow now charge for order flow. Moreover, the language of *Notice to Members 97-57* referred to arrangements "under which [the receiver of order flow] has implicitly or explicitly undertaken to provide best execution [to the routing broker/dealer's] customer orders."[6] In many current order routing arrangements, the receiver of order flow expressly states that it will not treat the routing member's orders as customer orders or that it does not owe a duty of best execution to the routing member's customer orders, in an apparent attempt to renounce any duty that it may owe to provide best execution to such orders.[7]

NASD staff believes that the application of the Best Execution Rule to a customer order should not depend on the method by which it is routed for execution and executed. It is unlikely that retail customers and routing broker/dealers appreciate the distinction between "customer" and "non-customer" orders that some members have maintained concerning the scope of the Best

Execution Rule. Furthermore, assuming that a member meets its "regular and rigorous" obligations, it is unreasonable to expect a routing broker/dealer to be the sole guarantor on an order-by-order basis of execution quality for that class of customer orders that it routes to another member for execution because of the difficulties of the routing member to monitor the execution of individual customer orders.[8]

NASD, therefore, solicits comment on whether to amend the Best Execution Rule to clarify that, under certain circumstances, the Best Execution Rule extends to customer orders routed by a broker/dealer to another broker/dealer for execution. Specifically, NASD seeks comment on whether the scope of the Best Execution Rule should be clarified to include customer orders received by a member from another broker/dealer and, if so, whether the scope of the duty in this circumstance should: (1) be 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) be limited to customer orders routed pursuant to an arrangement or an agreement noted in *Notice to Members 97-57* (*i.e.*, where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customers' orders or there is another arrangement between the two broker/dealers (such as a payment for order flow, reciprocal, or correspondent arrangement); (3) be limited to customer orders routed pursuant to an arrangement or an agreement (including, but not limited to, those noted in *Notice to Members 97-57*) where the recipient broker/dealer assesses a fee or charge to execute the order; (4) be defined more broadly to include all orders that are identified by the routing member as customer orders; and/or (5) clarified or amended in some other fashion. NASD also seeks 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).

Although NASD recognizes that the Best Execution Rule is a fundamental customer protection rule, NASD also recognizes that member firms may have concerns about the impact any change to the Best Execution Rule may have on potential liability and litigation issues. Accordingly, NASD is seeking comments from members, investors, and other interested parties on how best to address the important issues raised in this *Notice*.

Endnotes

1 Nothing in this *Notice* should be construed as an attempt to define or to change what constitutes satisfaction of the duty of best execution; rather, the purpose of this *Notice* is to request comments on whether and to what extent the scope of the duty of best execution should be clarified.

2 Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48322-48323 (September 12, 1996) (SEC Adopting Release). The SEC Adopting Release appears in its entirety as published in the *Federal Register* in the Appendix to *NASD Notice to Members 96-65* (October 1996). For the convenience of the reader, this *Notice* will cite to *NASD Notice to Members 96-65* when referencing the Adopting Release. *NASD Notice to Members 96-65* at 542.

3 Id.

4 *NASD Notice to Members 97-57* at 458 (September 1997).

5 Id.

6 Id.

7 Although NASD notes the practice by certain recipient firms of disclaiming best execution responsibilities for customer orders that are routed to them, it is not clear that such a practice has any legally operative effect on the best execution responsibilities owed to such routed orders or that such a practice otherwise comports with SEC, NASD or other legal obligations concerning best execution. Furthermore, a member firm should take such statements by recipient firms into account when making order routing decisions.

8 *See NASD Notice to Members 01-22* (April 2001). Nothing in this *Notice* changes the obligation of a member firm to regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security, as explained more fully in *Notice to Members 01-22*.