# Notice to Members

#### **SEPTEMBER 2006**

### **SUGGESTED ROUTING**

Internal Audit

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### **KEY TOPICS**

Net Trading Rule 2441

#### **GUIDANCE**

# **Net Trading Requirements**

SEC Approves New Rule 2441 Requiring Disclosure and Consent When Trading on a Net Basis with Customers;

Effective Date: October 2, 2006

# **Executive Summary**

On June 30, 2006, the Securities and Exchange Commission (SEC) approved new NASD Rule 2441, Net Transactions with Customers, which requires disclosure and consent when trading on a net basis with customers. Rule 2441, as adopted, is set forth in Attachment A of this *Notice*. The rule becomes effective on October 2, 2006.

# Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, Regulatory Policy and Oversight (RPO) at (240) 386-5126; or the Office of General Counsel, RPO at (202) 728-8071.

# Background and Discussion

On June 30, 2006, the SEC approved new NASD Rule 2441. Rule 2441 clarifies and codifies that a member is required to provide disclosure to, and obtain consent from, a customer prior to executing a transaction with a customer on a "net" basis. A "net" transaction means a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.<sup>2</sup>

The disclosure and consent requirements under the new rule differ depending on whether the member is trading with an institutional or non-institutional customer.<sup>3</sup>

- For non-institutional customers, a member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a net basis, and such consent must evidence the customer's understanding of the terms and conditions of the order.
- For institutional customers, a member must obtain the customer's consent prior to executing a transaction for or with the customer on a net basis. Consent may be obtained on an order-by-order basis or by use of a negative consent letter.
  - If using a negative consent letter, such letter must clearly disclose in writing the terms and conditions for handling the customer orders and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If the customer does not object, then the member may reasonably conclude that the institutional customer has consented to the member trading on a net basis with the customer and the member may rely on such letter for all or a portion of the customer's orders (as instructed by the customer).
  - A member also may obtain consent from institutional customers orally or in writing on an order-by-order basis. A member that chooses to obtain consent orally on an order-by-order basis also must clearly explain to the institutional customer, prior to each transaction, the terms and conditions for handling the order and provide the institutional customer with a meaningful opportunity to object to the execution of the transaction on a net basis. The member also must document, on an order-by-order basis, the customer's understanding of the terms and conditions of the order and the customer's consent.

If a customer has granted trading discretion to a fiduciary (e.g., an investment adviser), a member is permitted to obtain the consent required under Rule 2441 from the fiduciary. Further, if the fiduciary meets the definition of "institutional customer" in Rule 2441(e), the member may comply with the disclosure and consent requirements under Rule 2441 in the same manner permitted for institutional customers, notwithstanding the status of the ultimate customer.

New Rule 2441 becomes effective October 2, 2006.

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# Questions and Answers Relating to New Rule 2441

To assist members in understanding the application of new Rule 2441, NASD is publishing the following questions and answers.

#### Q1 What is a net transaction?

- As defined in Rule 2441, a "net" transaction means a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.
- Q2 Do the Rule 2441 consent and disclosure requirements apply to orders received from members and other registered broker-dealers?
- A2 No. Rule 2441 does not apply to orders received from member firms and other registered broker-dealers.
- Q3 What are the ways in which consent can be obtained from institutional customers under the rule?
- A3 As described in detail in Rule 2441(c), there are three methods for obtaining an institutional customer's consent. The member may obtain the institutional customer's consent prior to executing the customer's transaction on a net basis: (1) through the use of a negative consent letter; (2) orally, on an order-by-order basis; or (3) in writing on an order-by-order basis.

### Q4 What is an institutional customer?

- An institutional customer is a customer whose account qualifies as an "institutional account" under NASD Rule 3110(c)(4). Any customer whose account does not qualify as an institutional account under Rule 3110(c)(4) would be deemed a non-institutional customer.
- Q5 If I obtained a negative consent letter from my institutional customer, does that apply to all of the orders from that customer?
- A5 Depending on the institutional customer's instructions to the firm, the negative consent may apply to all or only a portion of the customer's orders.

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### Q6 Is negative consent permissible for non-institutional customers?

- A6 No, use of a negative consent letter is not a permissible method to obtain consent to trade on a net basis with a non-institutional customer. For non-institutional customers, a member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.
- Q7 How does the rule apply if the customer has granted trading discretion to a fiduciary?
- A7 Absent any instructions to the contrary, a member may look to the institutional or non-institutional status of the fiduciary, rather than the underlying account, when determining the Rule 2441 disclosure and consent requirements.
- Q8 When do the requirements in Rule 2441 go into effect?
- A8 The disclosure and consent requirements set forth in Rule 2441 become effective on October 2, 2006.

### **Endnotes**

- See Securities Exchange Act Release No. 54088 (June 30, 2006), 71 FR 38950 (July 10, 2006) (File No. SR-NASD-2004-135).
- 2 See Rule 2441(e).

3 An "institutional customer" is a customer whose account qualifies as an "institutional account" under Rule 3110(c)(4). Any customer whose account does not qualify as an institutional account under Rule 3110(c)(4) would be deemed a non-institutional customer.

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### ATTACHMENT A

New language is underlined.

## 2441. Net Transactions with Customers

- (a) Prior to executing a transaction for or with a customer on a "net" basis as defined in paragraph (e) below, a member must provide disclosure to and obtain consent from the customer as provided in this Rule.
- (b) With respect to non-institutional customers, the member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.
- (c) With respect to institutional customers, a member must obtain the customer's consent prior to executing a transaction for or with the customer on a "net" basis in accordance with one of the following methods:
  - (1) a negative consent letter that clearly discloses to the institutional customer in writing the terms and conditions for handling the customer order(s) and provides the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If the customer does not object, then the member may reasonably conclude that the institutional customer has consented to the member trading on a "net" basis with the customer and the member may rely on such letter for all or a portion of the customer's orders (as instructed by the customer) pursuant to this Rule;
  - (2) oral disclosure to and consent from the customer on an order-by-order basis. Such oral disclosure and consent must clearly explain the terms and conditions for handling the customer order and provide the institutional customer with a meaningful opportunity to object to the execution of the transaction on a net basis. The member also must document, on an order-by-order basis, the customer's understanding of the terms and conditions of the order and the customer's consent; or
  - (3) written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.
- (d) For those customers that have granted trading discretion to a fiduciary (e.g. an investment adviser), a member is permitted to obtain the consent required under this Rule from the fiduciary. If the fiduciary meets the definition of "institutional customer" in paragraph (e), the member may meet the disclosure and consent requirements under this Rule in the same manner permitted for institutional customers.

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- (e) For purposes of this Rule, (1) "institutional customer" shall mean a customer whose account qualifies as an "institutional account" under Rule 3110(c)(4); and (2) "net" transaction shall mean a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.
- (f) Members must retain and preserve all documentation relating to consent obtained pursuant to this Rule in accordance with Rule 3110(a).

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