

Notice to Members

OCTOBER 2006

SUGGESTED ROUTING

Legal & Compliance
Operations
Registered Representatives
Senior Management
Trading and Market Making

KEY TOPICS

Best Execution
Interpretive Material 2320
Rule 2320

GUIDANCE

Best Execution

SEC Approves Amendments to Rule 2320(a) Regarding Best Execution and New Interpretive Material 2320;
Effective Date: November 8, 2006

Executive Summary

On August 21, 2006, the Securities and Exchange Commission (SEC) approved amendments to Rule 2320(a), the Best Execution Rule, to require that a "recipient member," as that term is defined herein, provide best execution to all transactions for or with a customer of another broker-dealer. NASD also is amending the reasonable diligence factors in Rule 2320(a) and deleting the term "inter-dealer" in order to modernize the text of the Best Execution Rule. Further, NASD is adopting new Interpretive Material 2320 to codify interpretive guidance concerning the applicability of the Best Execution Rule.¹

The rules, as amended, are set forth in Attachment A. The amendments become effective on November 8, 2006.

Questions/Further Information

Questions concerning this *Notice* may be directed to Kathleen A. O'Mara, Associate General Counsel, Office of General Counsel at (202) 728-8071; and Peter D. Santori, Chief Counsel, Market Regulation, Regulatory Policy & Oversight, at (240) 386-5098.

Background and Discussion

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 resultant price to the customer is as favorable as possible under prevailing market conditions. NASD has received many questions regarding the application of the term “customer” in the context of best execution. Rule 0120(g) defines “customer” to exclude a broker or dealer, unless the context requires otherwise. For example, prior to these amendments, if a firm that received an order from a customer (“originating broker-dealer”) and routed the order to a member firm (“recipient member”) and the recipient member executed the order in a manner inconsistent with the Best Execution Rule, the recipient member could have argued that it had 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 that receive customer orders from other broker-dealers is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule.

As amended, Rule 2320(a) now requires that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer. Specifically, NASD has amended the Best Execution Rule to state that the rule governs “any transaction for or with a customer or a customer of another broker-dealer.” NASD believes this change will better ensure that customer orders receive equivalent best execution protections, irrespective of whether a customer order is executed by the originating broker-dealer or routed to a recipient member. It is important to note, however, that this expansion of the application of the Best Execution Rule to recipient members does not change the obligations of an originating broker-dealer member to examine regularly and rigorously execution quality likely to be obtained from different markets trading a security.²

NASD also has modernized the text of the Best Execution Rule. Rule 2320(a) 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, NASD has deleted the term “inter-dealer” from Rule 2320(a). This change clarifies that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all markets in which a security is traded.

Additionally, NASD has amended the reasonable diligence factors to reflect current market structure. To that end, NASD has (1) replaced the diligence factor of “the number of primary markets checked” with “the number of markets checked”; (2) replaced the diligence factor of “location and accessibility to the customer’s broker-dealer of primary markets and quotation sources” with “accessibility of the quotation”; and (3) added an additional diligence factor that takes into account “the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member” to reflect the importance of this consideration in assessing best execution.

Interpretive Material 2320

NASD has adopted new Interpretive Material 2320 (IM-2320) to codify interpretive guidance relating to Rule 2320(a). First, IM-2320 provides that, for purposes of Rule 2320, the term “market” or “markets” should be interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets and markets other than exchange markets, as well as any other trading venues that may emerge. In sum, the purpose of this change is to signal that no trading venues have less relevance than others in the course of best execution.

IM-2320 also clarifies that a member’s duty to provide best execution in any transaction “for or with a customer of another broker-dealer” does not apply in instances when another broker-dealer is simply executing a customer order against the member’s quote. The duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the originating broker-dealer to the recipient member for the purpose of order handling and execution. The duty of best execution does not apply in instances when another broker-dealer is simply executing a customer order against a member’s quote; that circumstance is distinct from those circumstances in which a recipient member is accepting order flow from an originating broker-dealer for the purpose of facilitating the handling and execution of such orders. The duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the broker-dealer to the member for the purpose of order handling and execution. This duty is subject to the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member (for example, a recipient member is not responsible for complying with the terms and conditions of an order that are incorrectly communicated by the originating broker-dealer either because such order contains the wrong terms and conditions or fails to include certain terms and conditions).

Finally, members should understand that, in the context of debt, the term “quotation” in the reasonable diligence factor in IM-2320 as to the “accessibility of the quotations” will be considered by NASD as referring to either dollar (or other currency) pricing or yield pricing.³

Endnotes

- 1 See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006) (Order Approving Proposed Rule Change and Amendment Nos. 1-5; File No. SR-NASD-2004-026).
- 2 See *Notice to Members 01-22* (April 2001), which 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.
- 3 NASD notes, however, that accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule 2320. In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

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ATTACHMENT A

New language is underlined; deleted language is in brackets.

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, 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) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

(2) the size and type of transaction;

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

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

(5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

(b) through (g) No change.

IM-2320. Interpretive Guidance with Respect to Best Execution Requirements

Rule 2320(a) requires, among other things, that a member or person associated with a member comply with Rule 2320(a) when customer orders are routed to it from another broker/dealer for execution. This Interpretive Material addresses certain interpretive questions concerning the applicability of the best execution rule.

The term “market” has been in the text of Rule 2320 since its adoption, but it is an undefined term. For the purposes of Rule 2320, the term “market” or “markets” is to be construed broadly and it encompasses a variety of different venues, including, but not limited to, market centers that are trading a particular security. This expansive interpretation is meant to both inform broker/dealers as to the breadth of the scope of venues that must be considered in the furtherance of their best execution obligations and to promote fair competition among broker/dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of determining a firm’s best execution obligations.

Rule 2320(a)(4) provides that one of the factors used to determine if a member has used reasonable diligence in exercising best execution is the “location and accessibility to the customer’s broker/dealer of primary markets and quotations sources.” In the context of the debt market, this means that, when quotations are available, NASD will consider the “accessibility of such quotations” when examining whether a member has used reasonable diligence. For purposes of debt securities, the term “quotation” refers to either dollar (or other currency) pricing or yield pricing. NASD notes, however, that accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule 2320. In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

Lastly, NASD is clarifying that a member’s duty to provide best execution in any transaction “for or with a customer of another broker/dealer” does not apply in instances when another broker/dealer is simply executing a customer order against the member’s quote. Stated in another manner, the duty to provide best execution to customer orders received from other broker/dealers arises only when an order is routed from the broker/dealer to the member for the purpose of order handling and execution. This clarification is intended to draw a distinction between those situations in which the member is acting solely as the buyer or seller in connection with orders presented by a broker/dealer against the member’s quote, as opposed to those circumstances in which the member is accepting order flow from another broker/dealer for the purpose of facilitating the handling and execution of such orders.