

Notice to Members

JUNE 2007

SUGGESTED ROUTING

Fixed Income
Trading and Market Making
Sales
Senior Management
Legal and Compliance
Internal Audit
Training

KEY TOPICS

Mark-Ups
Debt Securities
Rule 2440
Pricing of Debt Securities

GUIDANCE

Mark-Ups on Debt Securities

SEC Approves Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities; **Effective Date: July 5, 2007**

Executive Summary

On April 16, 2007, the Securities and Exchange Commission (SEC) approved IM-2440-2, "Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities" (Debt Mark-Up Interpretation or Interpretation), and renumbered IM-2440 as IM-2440-1.¹ The Debt Mark-Up Interpretation supplements Rule 2440, "Fair Prices and Commissions," which requires broker-dealers to charge customers fair mark-ups and commissions, and IM-2440-1, "Mark-Ups."

In a debt security transaction with a customer, the broker-dealer's mark-up (mark-down) must be calculated from the prevailing market price of that security. The new Debt Mark-Up Interpretation states that, presumptively, the prevailing market price of a debt security is the broker-dealer's contemporaneous cost (or, in a sale, the broker-dealer's contemporaneous proceeds).

The Interpretation also addresses the procedures for determining prevailing market price (as a price other than contemporaneous cost) when a broker-dealer has the discretion, under the Interpretation, not to use its contemporaneous cost as the measure. In addition, the Interpretation includes an exemption for transactions in non-investment grade debt securities between broker-dealers and qualified institutional buyers (QIBs), as defined in Rule 144A under the Securities Act of 1933 (Securities Act) (QIB Exemption).² The Interpretation and the amendment to IM-2440 are set forth in Attachment A of this *Notice*.

The Interpretation and the amendment to IM-2440 become effective July 5, 2007.

Questions/Further Information

Questions regarding this *Notice* may be directed to Sharon K. Zackula, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985; Malcolm P. Northam, Director, Fixed Income Securities Regulation, Regulation Policy, Member Regulation, at (202) 728-8085; and the Legal Section, Market Regulation, at (240) 386-5126.

Background

Generally, under NASD Rule 2440 and IM-2440-1, broker-dealers may not charge compensation for the execution of customer transactions, whether in the form of a mark-up (mark-down) or commission, that is unfair, unreasonable or excessive. Unfair, unreasonable or excessive compensation for customer trades also violates Rule 2110, which requires broker-dealers to conduct their business in accordance with just and equitable principles of trade.³ The Debt Mark-Up Interpretation approved on April 16, 2007, supplements Rule 2440 and IM-2440-1.⁴

Rule 2440, IM-2440-1 and the Interpretation apply to transactions in debt securities between a broker-dealer and a customer except transactions in municipal securities, as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 (Act),⁵ and exempted securities (other than municipal securities), as defined in Section 3(a)(12) of the Act.⁶

Prevailing Market Price

In a debt security transaction with a customer, the broker-dealer's mark-up (mark-down) must be calculated from the prevailing market price of that security. The Debt Mark-Up Interpretation focuses particularly on the key issue of the proper identification of the prevailing market price. The Interpretation states that, presumptively, the prevailing market price of a debt security is the broker-dealer's contemporaneous cost (or, in a sale, the broker-dealer's contemporaneous proceeds).⁷ The Interpretation also addresses the procedures for determining prevailing market price (as a price other than contemporaneous cost) when a broker-dealer, under the Interpretation, may choose not to use its contemporaneous cost as the measure of the prevailing market price. This occurs when there is no contemporaneous cost (proceeds) or certain events have occurred, as discussed on the next page.

Contemporaneous Cost

A broker-dealer may seek to overcome the presumption that its contemporaneous cost (proceeds) is indicative of the prevailing market price in any of three events:

- (i) interest rates changed after the broker-dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing;
- (ii) the credit quality of the debt security changed significantly after the broker-dealer's contemporaneous transaction; or
- (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the broker-dealer's contemporaneous transaction.⁸

Pricing Alternatives to Contemporaneous Cost

Hierarchy

When the broker-dealer has no contemporaneous transaction, or any of the events set forth above have occurred, the Debt Mark-Up Interpretation identifies three factors that must be considered, in the order listed, to determine the prevailing market price (hierarchy pricing factors). As set out more fully in the Interpretation, the hierarchy pricing factors are as follows in the order of consideration: contemporaneous inter-dealer transactions in the same security; qualifying contemporaneous institutional account-dealer trades in the same security; or qualifying contemporaneous quotations.⁹ The broker-dealer must determine that the relevant pricing information does not exist in each of the hierarchy pricing factors in their specified order before proceeding to any consideration of the next factor.

"Similar" Securities

If none of the three hierarchy pricing factors are determinative of the relevant pricing information, the broker-dealer may then consider the pricing information from "similar" securities.¹⁰ The Interpretation provides specific guidance about what constitutes "similar" securities for purposes of the Interpretation.¹¹ A broker-dealer should consider, among other things, credit quality of both securities, ratings, collateralization, spreads (over U.S. Treasury securities of similar duration) at which the securities are usually traded, general structural similarities (such as calls, maturity, embedded options), the size of the issue, float, recent turnover, and transferability or restrictions thereto.¹² Also, the Interpretation recognizes that there may not be "similar" securities for certain securities.¹³ Generally, a "similar" security should be sufficiently equivalent to the subject security that it would serve as a reasonably fungible alternative investment. In addition, at a minimum, a broker-dealer must be able to fairly estimate the market yield for the subject security from the yields of "similar" securities.¹⁴

The pricing factors incorporating “similar” securities are not hierarchal; that is, they may be considered in any order. However, when reviewing them, the broker-dealer must consider that the burden on the broker-dealer is the correct identification of the prevailing market price.¹⁵

Economic Models

Finally, where neither the hierarchy pricing factors nor similar securities can be used to establish the prevailing market price, the Debt Mark-Up Interpretation allows that the broker-dealer may use pricing information derived from an economic model to determine the prevailing market price of a debt security for purposes of a mark-up.¹⁶

An economic model used to identify prevailing market price must take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded option, coupon rate and face value, and all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods).¹⁷

The Qualified Institutional Buyer (QIB) Exemption

The Interpretation contains a QIB Exemption, removing certain institutional customer transactions from the requirements of Rule 2440, IM-2440-1 and the Interpretation.¹⁸ To rely upon the QIB Exemption, a broker-dealer must determine that:

- (i) the customer is a QIB as defined in Rule 144A under the Securities Act;
- (ii) the security that the QIB wishes to buy or sell is a non-investment grade debt security as defined for purposes of IM-2440-2; and
- (iii) after considering the factors set forth in IM-2310-3, which addresses institutional customer suitability factors, the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction to which the broker-dealer seeks to apply the exemption.¹⁹

If the broker-dealer establishes all three elements, then the QIB Exemption may be applied by the broker-dealer.

IM-2310-3 contains extensive factors to be considered in making the determination as to whether a QIB has the expertise to make an independent decision in respect of a transaction and in fact is making an independent decision. Therefore, members are advised to fully review this rule when applying the QIB exemption.

NASD is providing 30 days from publication of this *Notice* for implementation to provide members with adequate time to comply with the amended requirements. As such, the amendments become effective July 5, 2007.

Endnotes

- 1 See Securities Exchange Act Release No. 55638 (April 16, 2007), 77 FR 20150 (April 23, 2007) (File No. SR-NASD-2003-141) (approval order).

In this *Notice*, the term “mark-up” generally refers to both mark-ups and mark-downs, and the term “contemporaneous cost” refers to both contemporaneous cost and contemporaneous proceeds (or either of them). Single terms in parentheses within sentences, such as the term “(proceeds),” refer specifically to customer sale transactions where the member charges a mark-down.
- 2 Under Rule 144A of the Securities Act of 1933 (Securities Act), the definition of QIB includes, among others: (1) specified entities (including insurance companies, registered investment companies, employee benefit plans or similar plans maintained by a state, or a state agency or political subdivision, and investment advisors) that act for their own account or the accounts of other QIBs, that in the aggregate own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity; (2) any broker-dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934 (Act), acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least \$10 million of securities of issuers that are not affiliated with the broker-dealer; (3) any broker-dealer acting in a riskless principal transaction on behalf of a QIB; (4) any investment company registered under the Investment Company Act of 1940, acting for its own account or for the accounts of other QIBs, that is part of a family of investment companies that own in the aggregate at least \$100 million in securities of issuers, other than issuers that are affiliated with the investment company or are part of such family of investment companies; and (5) any bank or certain other domestic and foreign financial institutions, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with it and that has an audited net worth of at least \$25 million.
- 3 A broker-dealer may also be liable for excessive mark-ups under the anti-fraud provisions of the Securities Act and the Act. See Section 10(b)(5) of the Act and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act.
- 4 See IM-2440-2, paragraph (a)(1).
- 5 See Section 3(a)(29) of the Act. “Municipal securities” include, among others, tax-exempt general obligation bonds and tax-exempt industrial revenue bonds. Transactions in municipal securities involving unfair pricing, including unfair mark-ups, are subject to the rules of the Municipal Securities Rulemaking Board (MSRB) and the anti-fraud provisions of the Securities Act and the Act. See note 3.
- 6 See Section 3(a)(12) of the Act. “Exempted securities” include, among others: government securities, as defined in Section 3(a)(42) of the Act; municipal securities, as defined in Section 3(a)(29) of the Act; any interest in any common trust fund or similar fund that is excluded from the definition of the term “investment company” under the Investment Company Act of 1940; any interest in any common trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation or security is issued in connection with a qualified plan; any security issued by or any interest or participation in any pooled income fund, collective trust fund, collective investment fund, or similar fund that is excluded from the definition of an investment company; certain securities issued by or any interest in any church plan, company, or account that is excluded from the definition of an investment company; and other securities that the Commission may, by rules, exempt from any one or more provisions of the federal securities laws

NASD Rule 2110 (J&E rule) applies to broker-dealers charging excessive mark-ups or commissions in exempted securities transactions (other than municipal securities transactions). See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (SR-NASD-1995-39) (order approving

the application of the NASD's Rules of Fair Practice to transactions in exempted securities (except municipal securities)). In the order, the Commission states that for transactions in government securities between broker-dealers and customers, NASD may address conduct that is "similar to conduct that may violate the 'Fair Prices and Commissions' provision and the 'Mark-Up Policy'" under Rule 2110. The Commission said an NASD statement in the rule filing regarding this application of the J&E rule "merely clarifies and reminds members that its rules requiring members to adhere to just and equitable principles of trade apply to conduct that may violate the Fair Prices and Commissions provision and the Mark-Up Policy..." and the "rule requiring that members adhere to just and equitable principles of trade would have applied to such conduct regardless of this clarification." 61 FR 44100, 44113. Also, such conduct is subject to the anti-fraud provisions of the Securities Act and the Act. See note 3. See also NASD Rule 0116, paragraph (b).

- 7 See IM-2440-2, paragraphs (b)(1), (2) and (4).
- 8 See IM-2440-2, paragraph (b)(4).
- 9 See IM-2440-2, paragraphs (b)(5)(A) through (C).
- 10 See IM-2440-2, paragraph (b)(6).
- 11 See IM-2440-2, paragraphs (c)(1) and (2).
- 12 See IM-2440-2, paragraphs (c)(2)(A) through (D).
- 13 See IM-2440-2, paragraph (c)(3).
- 14 See IM-2440-2, paragraph (c)(1).
- 15 See IM-2440-2, paragraphs (b)(6) and (b)(8).
- 16 See IM-2440-2, paragraph (b)(7).
- 17 *Id.*
- 18 See IM-2440-2, paragraph (b)(9).
- 19 *Id.*

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ATTACHMENT A

New language is underlined; deletions are 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.

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IM-2440-2. Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities¹

(a) Scope

(1) IM-2440-1 applies to debt securities transactions, and this IM-2440-2 supplements the guidance provided in IM-2440-1.

(b) Prevailing Market Price

(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 for purposes of this IM-2440-2, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with NASD pricing rules. (See, e.g., Rule 2320).

(2) 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 in the security 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 in the security or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

(3) A dealer's cost is considered contemporaneous if the transaction occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the security. (Where a mark-down is being calculated, a dealer's proceeds would be considered contemporaneous if the transaction from which the proceeds result occurs close enough in time to the subject transaction that such proceeds would reasonably be expected to reflect the current market price for the security.)

(4) 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, in a mark-down, the dealer's own proceeds) must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or, the dealer's proceeds) provides the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost is (or proceeds are) not indicative of prevailing market price, and thus overcome the presumption, in instances where (i) interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing; (ii) the credit quality of the debt security changed

significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.

(5) In instances where the dealer has established that the dealer's cost is (or, in a mark-down, proceeds are) no longer contemporaneous, or where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or proceeds) provides the best measure of the prevailing market price, such as those instances described in (b)(4)(i), (ii) and (iii), a member must consider, in the order listed, the following types of pricing information to determine prevailing market price:

(A) Prices of any contemporaneous inter-dealer transactions in the security in question;

(B) In the absence of transactions described in (A), prices of contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts with which any dealer regularly effects transactions in the same security; or

(C) In the absence of transactions described in (A) and (B), 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.

(A member may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information (e.g., a member may consider pricing information under (B) only after the member has determined, after applying (A), that there are no contemporaneous inter-dealer transactions in the same security). In reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information (i.e., either a particular transaction price, or, in (C) above, a particular quotation) depends on the facts and circumstances of the comparison transaction or quotation (i.e., such as whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction and timeliness of the information).

(6) In the event that, in particular circumstances, the above factors 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);

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- Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” securities;
 - Yields calculated from prices of contemporaneous dealer 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, for purposes of identifying prevailing market price, of the pricing information obtained from the factors set forth above depends on the facts and circumstances surrounding the comparison transaction (i.e., whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, 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).

(7) Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, NASD or its members may consider as a factor in assessing the prevailing market price of a debt security the prices or yields derived from economic models (e.g., discounted cash flow models) that take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value; and consider all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods). Such models currently may be in use by bond dealers or may be specifically developed by regulators for surveillance purposes.

(8) 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.

(9) "Customer," for purposes of Rule 2440, IM-2440-1 and this IM-2440-2, shall not include a qualified institutional buyer ("QIB") as defined in Rule 144A under the Securities Act of 1933 that is purchasing or selling a non-investment grade debt security when the dealer has determined, after considering the factors set forth in IM-2310-3, that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction. For purposes of Rule 2440, IM-2440-1 and this IM-2440-2, "non-investment grade debt security" means a debt security that: (i) if rated by only one nationally recognized statistical rating organization ("NRSRO"), is rated lower than one of the four highest generic rating categories; (ii) if rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by any of the NRSROs; or (iii) if unrated, either was analyzed as a non-investment grade debt security by the dealer and the dealer retains credit evaluation documentation and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the credit quality of the security is, in fact, equivalent to a non-investment grade debt security, or was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933.

(c) "Similar" Securities

(1) A "similar" security should be sufficiently similar to the subject security 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 subject security 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.

(2) The degree to which a security is "similar," as that term is used in this IM-2440-2, to the subject security may be determined by factors that include but are not limited to 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 (to the extent securities of other issuers are designated as "similar" securities, significant recent information of either issuer that is not yet incorporated in credit ratings should be considered (e.g., changes to ratings outlooks));

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

(C) General structural characteristics and provisions 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.

(3) 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. Single terms in parentheses within sentences, such as the terms "(sale)" and "(to)" in the phrase, "contemporaneous dealer purchase (sale) transactions with institutional accounts," refer to scenarios where a member is charging a customer a mark-down.