

Fair Prices and Commissions

SEC Approves Amendments to Expand the Scope of NASD Rule 2440 and IM-2440-1 to All Securities Transactions

Effective Date: June 13, 2008

Executive Summary

Effective June 13, 2008, the requirements in NASD Rule 2440 and IM-2440-1 relating to fair prices and commissions expressly apply to all securities transactions involving member firms and their customers, whether executed over-the-counter or on an exchange.¹ The text of Rule 2440 and IM-2440-1, as amended, is set forth in Attachment A of this *Notice*.

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

Background and Discussion

NASD Rule 2440 (Fair Prices and Commissions) generally requires member firms, in any over-the-counter (OTC) transaction with or for a customer, to charge only fair commissions or charges, and to buy or sell securities only at fair prices. Specifically, Rule 2440 provides that when acting for its own account in a transaction with a customer, a member firm must buy or sell the security at a fair price to the customer, "taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that [the firm] is entitled to a profit." Additionally, the Rule provides that when acting as agent on behalf of its customer, the firm must not "charge [its] customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service [the firm] may have rendered by reason of [its] experience in and knowledge of such security and the market therefore."

July 2008

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Operations
- Senior Management
- Systems
- Trading
- Training

Key Topic(s)

- Commissions
- Mark-Downs
- Mark-Ups
- Mark-Up Policy
- Prices

Referenced Rules & Notices

- NASD IM-2440-1
- NASD IM-2440-2
- NASD Rule 2110
- NASD Rule 2440

The related Mark-Up Policy, NASD IM-2440-1, provides additional guidance on mark-ups and fair pricing of securities transactions with customers, and states that it is inconsistent with just and equitable principles of trade under NASD Rule 2110 for a member firm 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 that is not reasonable.²

Although the text of Rule 2440 and IM-2440-1 was limited to OTC transactions prior to the recent amendments, FINRA has taken the position that a firm charging excessive compensation in a transaction with a customer executed on an exchange violates Rule 2110. That Rule requires that a member firm must, in the conduct of its business, “observe high standards of commercial honor and just and equitable principles of trade.”³

To further clarify firms’ obligations to charge fair commissions and mark-ups (or mark-downs), FINRA proposed, and the Securities and Exchange Commission (SEC) approved, amendments to Rule 2440 and IM-2440-1 to apply these provisions expressly to all securities transactions, whether they occur in the OTC market or on an exchange.⁴ Thus, a member firm that charges unfair and excessive commissions or mark-ups (mark-downs) in any customer transaction, whether it is an OTC or exchange transaction, would potentially violate Rule 2440 and the interpretive material thereunder, as applicable.

These amendments became effective on June 13, 2008, the SEC approval date.

Endnotes

- 1 See Securities Exchange Act Release No. 57964 (June 13, 2008), 73 FR 35180 (June 20, 2008) (order approving SR-NASD-2006-005).
- 2 Subsequent to the filing of the amendments described herein, the SEC approved amendments that, among other things, renumbered IM-2440 as IM-2440-1 and adopted NASD IM-2440-2, which supplements the guidance provided in IM-2440-1. See Securities Exchange Act Release No. 55638 (April 16, 2007), 72 FR 20150 (April 23, 2007) (order approving SR-NASD-2003-141). Accordingly, the revised scope of Rule 2440 and IM-2440-1 described herein also applies to IM-2440-2.
- 3 See Rule 2110. See also *Atlanta-One, Inc. v. SEC*, 100 F.3d 105, 107 n.1 (9th Cir. 1996), which states “[a]lthough [Rule 2440] deals with the appropriate level of compensation in retail transactions in the over-the-counter market, the [Rule] provides guidance by analogy as to appropriate commissions for exchange transactions.”
- 4 Currently, Rule 2440 and IM-2440-1 do not apply to transactions in municipal securities and exempt securities, nor do they apply to member firm-to-member firm transactions. The amendments do not change this.

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ATTACHMENT A

Below is the text of the rule changes. New language is underlined; deletions are in brackets.

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2440. Fair Prices and Commissions

In [“over-the-counter”]securities transactions, whether in “listed” or “unlisted” securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefore.

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 (b) No change.

(c) Transactions to Which the Policy is Applicable

The policy applies to all securities[handled in the over-the-counter market], whether oil royalties or any other security, in the following types of transactions:

(1) through (5) No change.

(d) No change.

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