

Barbara Z. Sweeney  
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February 11, 2004

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-2004-026 – Proposed Amendments to Rule 2320(a),  
NASD's Best Execution Rule**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Kathleen A. O'Mara, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8056; e-mail [kathleen.omara@nasd.com](mailto:kathleen.omara@nasd.com). The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney  
Senior Vice President  
and Corporate Secretary

Enclosures

File No. SR-NASD-2004-026  
Consists of 67 Pages  
February 11, 2004

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 2320(a) (“Best Execution Rule”). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

**2300. TRANSACTIONS WITH CUSTOMERS**

\* \* \* \* \*

**2320. Best Execution and Interpositioning**

(a) (1) In any transaction for or with a customer, 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)](A) [T]the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

[(2)](B) the size and type of transaction;

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

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

(2) For purposes of subparagraph (a)(1) only, the term "customer" also shall include a customer of a broker/dealer that originates an order on behalf of the customer (the "originating broker/dealer") and directs it to a member (the "recipient member"), provided there is a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that the recipient member and persons associated with the recipient member will provide best execution to such order in conformity with subparagraph (a)(1). Nothing in this subparagraph (a)(2) changes the application of subparagraph (a)(1) to the originating broker/dealer with respect to such order or requires the recipient member to enter into such an agreement.

(b) through (g) No change.

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 12, 2003, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its

Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on November 13, 2003. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Kathleen A. O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8056.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

**Background**

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 price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term "customer," in the context of best execution. NASD Rule 0120(g) defines "customer" as not including a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order

from a customer (“originating broker/dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could attempt to maintain that it has 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 may be contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker/dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice.<sup>1</sup> The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.

### **Proposal**

NASD is proposing to amend the Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a

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<sup>1</sup> Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that it will provide best execution to the originating broker/dealer's customer orders. The proposed rule change also would clarify that the recipient member is not required to enter into any such written agreements with the originating broker/dealer and that the originating broker/dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists.

NASD believes that the proposed rule change will provide better clarity to members and will establish a fair standard that explicitly extends best execution requirements to recipient members under specific circumstances.<sup>2</sup> Further, NASD believes that the proposed rule change will enhance NASD's ability to pursue actions for failure to provide best execution where a recipient member has not provided best execution as expressly agreed to or represented in writing.<sup>3</sup>

As noted above, an originating broker/dealer that is a member remains obligated to comply with the Best Execution Rule, even where a recipient member has agreed to provide best execution for orders routed to it. As such, the proposed rule change does

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<sup>2</sup> In Notice to Members 97-57 (September 1997), 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. In addition, NASD identified specific circumstances that would give rise to a duty of best execution. Where applicable, the proposed rule change would modify the circumstances set forth in that Notice. For example, an implicit arrangement to provide best execution will not be inferred when an originating broker/dealer and a recipient member enter into a payment for order flow, reciprocal, or correspondent arrangement. In general, a written agreement or written representation would be needed to give rise to a recipient member's duty of best execution under Rule 2320.

<sup>3</sup> In egregious situations, NASD staff may bring an action against the recipient member under Rule 2120, Use of Manipulative, Deceptive or Other Fraudulent Devices, even if no written agreement or representation were provided.

not alter the obligation of an originating broker/dealer to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. NASD, however, expects that the existence of a written agreement or representation from a recipient member that it will provide best execution will be a significant factor in determining whether the originating broker/dealer has met its best execution obligations when routing customer orders to another member.

As discussed above, the obligations specified in Rule 2320(a)(2) are triggered when a recipient member enters into a written agreement or makes written representation that it will provide best execution to customer orders routed to the recipient member by the originating broker/dealer. NASD staff envisions that written representations that trigger Rule 2320(a)(2) could come in a variety of forms. For example, such written representations could be distributed by the recipient member via its Web site, promotional literature, or in its advertising.<sup>4</sup> Moreover, where representations by a recipient member as to best execution do not specify a definite term for which the recipient member will provide best execution, recipient members will be responsible for providing best execution unless specifically revoked in writing. In addition, an originating broker/dealer will need to verify periodically that the representation has not been revoked.

NASD staff believes that it would be inappropriate for an originating broker/dealer to rely upon a negative consent letter as an agreement or a representation by a recipient member that the recipient member would comply with Rule 2320 or provide best

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<sup>4</sup> Depending upon the delivery method of the written representation, members should be aware of the possible need to comply with the provisions set forth in Rule 2210 “Communications with the Public” and Rule 2211 “Institutional Sales Material and Correspondence.”



execution with respect to the originating broker/dealer's customer orders. Accordingly, a negative consent letter would not be considered a written agreement or representation under Rule 2320(a)(2).

NASD members will be required to retain copies of all written agreements and written representations that trigger obligations under Rule 2320. Pursuant to Rule 3110(a), written agreements are considered member records and, therefore, must be preserved by both the recipient member and originating broker/dealer member. In addition, written representations regarding best execution made by the recipient member also should be preserved by the recipient member. Furthermore, an originating broker/dealer member that relies upon a written representation as to best execution should preserve a copy of that representation in its records.

NASD also is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule 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, including the recent expansion of trading in Nasdaq securities to national securities exchanges, NASD is proposing to delete the term "inter-dealer" from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to "inter-dealer" markets, but may include all market centers in which a security is traded.

Upon SEC approval of this rule proposal, NASD will notify members of the amendments and issue interpretive guidance consistent with the interpretive positions specified in this rule filing in a Notice to Members.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm 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. NASD believes that the proposed rule change will provide better clarity to members and will enhance NASD's ability, under specific circumstances, to pursue actions for failure to provide best execution.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

As discussed in the Purpose section above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another

broker/dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) 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) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customer orders or there is another arrangement between the two broker/dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker/dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker/dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited 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).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty

with respect to customer orders received from another broker/dealer.<sup>5</sup> Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker/dealer as customer orders. Lastly, similar to the approach in the proposed rule change, two commenters articulated that the receiving broker/dealer should only have a duty of best execution under Rule 2320 when the receiving broker/dealer has explicitly agreed to handle orders received from the originating broker/dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.<sup>6</sup> In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests.

After considering the comments received in response to the Notice, NASD is proposing to amend the Best Execution Rule as discussed herein.

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<sup>5</sup> See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

<sup>6</sup> See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

2. NASD Notice to Members 02-40 (July 2002).

3. Comments received in response to NASD Notice to Members 02-40 (July 2002).

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: \_\_\_\_\_  
Barbara Z. Sweeney, Senior Vice President and  
Corporate Secretary

Date: February 11, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2004-026)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend NASD's Best Execution Rule

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association of Securities Dealers, Inc. ("NASD"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend Rule 2320(a) ("Best Execution Rule"). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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**2300. TRANSACTIONS WITH CUSTOMERS**

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<sup>1</sup> 15 U.S.C. § 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

**2320. Best Execution and Interpositioning**

(a) ~~(1)~~ In any transaction for or with a customer, 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)](A)~~ ~~[T]~~the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

~~[(2)](B)~~ the size and type of transaction;

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

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

(2) For purposes of subparagraph (a)(1) only, the term “customer” also shall include a customer of a broker/dealer that originates an order on behalf of the customer (the “originating broker/dealer”) and directs it to a member (the “recipient member”), provided there is a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that the recipient member and persons associated with the recipient member will provide best execution to such order in conformity with subparagraph (a)(1). Nothing in this subparagraph (a)(2) changes the application of subparagraph (a)(1) to the originating broker/dealer with respect to such order or requires the recipient member to enter into such an agreement.

(b) through (g) No change.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

**Background**

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 price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term “customer,” in the context of best execution. NASD Rule 0120(g) defines “customer” as not including a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer (“originating broker/dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could attempt to maintain



that it has 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 may be contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker/dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice.<sup>3</sup> The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.

### **Proposal**

NASD is proposing to amend the Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that it will provide best execution to the originating broker/dealer’s customer orders. The proposed rule change also would clarify that the recipient member is not required to enter into any such written agreements with

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<sup>3</sup> Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

the originating broker/dealer and that the originating broker/dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists.

NASD believes that the proposed rule change will provide better clarity to members and will establish a fair standard that explicitly extends best execution requirements to recipient members under specific circumstances.<sup>4</sup> Further, NASD believes that the proposed rule change will enhance NASD's ability to pursue actions for failure to provide best execution where a recipient member has not provided best execution as expressly agreed to or represented in writing.<sup>5</sup>

As noted above, an originating broker/dealer that is a member remains obligated to comply with the Best Execution Rule, even where a recipient member has agreed to provide best execution for orders routed to it. As such, the proposed rule change does not alter the obligation of an originating broker/dealer to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. NASD, however, expects that the existence of a written agreement or representation from a recipient member that it will provide best execution will be a significant factor in

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<sup>4</sup> In Notice to Members 97-57 (September 1997), 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. In addition, NASD identified specific circumstances that would give rise to a duty of best execution. Where applicable, the proposed rule change would modify the circumstances set forth in that Notice. For example, an implicit arrangement to provide best execution will not be inferred when an originating broker/dealer and a recipient member enter into a payment for order flow, reciprocal, or correspondent arrangement. In general, a written agreement or written representation would be needed to give rise to a recipient member's duty of best execution under Rule 2320.

<sup>5</sup> In egregious situations, NASD staff may bring an action against the recipient member under Rule 2120, Use of Manipulative, Deceptive or Other Fraudulent Devices, even if no written agreement or representation were provided.

determining whether the originating broker/dealer has met its best execution obligations when routing customer orders to another member.

As discussed above, the obligations specified in Rule 2320(a)(2) are triggered when a recipient member enters into a written agreement or makes written representation that it will provide best execution to customer orders routed to the recipient member by the originating broker/dealer. NASD staff envisions that written representations that trigger Rule 2320(a)(2) could come in a variety of forms. For example, such written representations could be distributed by the recipient member via its Web site, promotional literature, or in its advertising.<sup>6</sup> Moreover, where representations by a recipient member as to best execution do not specify a definite term for which the recipient member will provide best execution, recipient members will be responsible for providing best execution unless specifically revoked in writing. In addition, an originating broker/dealer will need to verify periodically that the representation has not been revoked.

NASD staff believes that it would be inappropriate for an originating broker/dealer to rely upon a negative consent letter as an agreement or a representation by a recipient member that the recipient member would comply with Rule 2320 or provide best execution with respect to the originating broker/dealer's customer orders. Accordingly, a negative consent letter would not be considered a written agreement or representation under Rule 2320(a)(2).

NASD members will be required to retain copies of all written agreements and written representations that trigger obligations under Rule 2320. Pursuant to Rule

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3110(a), written agreements are considered member records and, therefore, must be preserved by both the recipient member and originating broker/dealer member. In addition, written representations regarding best execution made by the recipient member also should be preserved by the recipient member. Furthermore, an originating broker/dealer member that relies upon a written representation as to best execution should preserve a copy of that representation in its records.

NASD also is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule 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, including the recent expansion of trading in Nasdaq securities to national securities exchanges, NASD is proposing to delete the term “inter-dealer” from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all market centers in which a security is traded.

Upon SEC approval of this rule proposal, NASD will notify members of the amendments and issue interpretive guidance consistent with the interpretive positions specified in this rule filing in a Notice to Members.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must

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<sup>6</sup> Depending upon the delivery method of the written representation, members should be aware of the possible need to comply with the provisions set forth in Rule 2210 “Communications with the Public” and Rule 2211 “Institutional Sales Material and Correspondence.”

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm 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. NASD believes that the proposed rule change will provide better clarity to members and will enhance NASD's ability, under specific circumstances, to pursue actions for failure to provide best execution.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

As discussed in the Purpose section above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another broker/dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) 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) limited to customer

orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker/dealer agrees to provide automated executions to a routing broker/dealer's customer orders or there is another arrangement between the two broker/dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker/dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker/dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited 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).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker/dealer.<sup>7</sup> Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker/dealer as customer orders. Lastly,

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<sup>7</sup> See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

similar to the approach in the proposed rule change, two commenters articulated that the receiving broker/dealer should only have a duty of best execution under Rule 2320 when the receiving broker/dealer has explicitly agreed to handle orders received from the originating broker/dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.<sup>8</sup> In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests.

After considering the comments received in response to the Notice, NASD is proposing to amend the Best Execution Rule as discussed herein.

### III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>8</sup> See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-NASD-2004-026. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland  
Deputy Secretary