

September 1, 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-2004-135 – Disclosure and Consent Requirements When Trading on a Net Basis With Customers

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 Andrea Orr, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8156; e-mail andrea.orr@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Marc Menchel
Executive Vice President
and General Counsel

Enclosures

File No. SR-NASD-2004-135
Consists of 18 Pages
September 1, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

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 (“Exchange Act” or “Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) proposed NASD Rule 2441 to clarify and codify the staff position that market makers that intend to trade on a net basis with their customers are required to provide disclosure to, and obtain affirmative consent from, non-institutional customers on an order-by-order basis and obtain consent from institutional customers, which may be evidenced by the use of a negative consent letter. Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

2441. Net Transactions with Customers

(a) Prior to executing a transaction with a customer on a “net” or similar basis as defined in paragraph (d) 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” or similar basis and such consent must evidence the customer’s understanding of the terms and conditions of the order. For those non-institutional customers that have granted trading discretion to a fiduciary (e.g. an investment advisor), a member is permitted to obtain such consent from the fiduciary.

(c) With respect to institutional customers, a member may obtain customer consent through the use of a negative consent letter prior to executing a transaction for or with the

customer on a “net” or similar basis. If evidencing the consent of an institutional customer through the use of a negative consent letter, before obtaining such consent, a member must clearly disclose to the institutional customer in writing the terms and conditions for handling the customer order(s) and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If no objection from the customer is received, then the member may reasonably conclude that the institutional customer has consented to the member trading on a “net” or similar basis with the customer and the member may rely on such letter for all of the customer’s orders (unless instructed otherwise) pursuant to this Rule.

(d) For purposes of this Rule, (1) “institutional customer” shall mean a customer that 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.

(e) Members must retain and preserve all documentation relating to consent obtained pursuant to this Rule in accordance with Rule 3110(a).

* * * * *

(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 July 21, 2004, 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 had an opportunity to review the proposed rule at its meeting on July 22, 2004. 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 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 Andrea Orr, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8156.

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

(a) Purpose

A riskless principal transaction is a transaction in which a member, after having received a customer order executes an offsetting transaction, as principal, with another customer or broker-dealer to fill that customer order and both transactions are executed at the same price. NASD announced amendments to the trade reporting rules that required qualifying riskless principal transactions of market makers to be the subject of a single trade report.¹ Prior to these amendments, both legs of a riskless principal transaction were reported. The amendments stipulated that a riskless principal transaction qualified for a single trade report where each side

¹ See *Notice to Members 99-65* (August 1999).

of the trade was executed at the same price, exclusive of any mark-up, mark-down, commission equivalent or other fee. The trade reporting amendments in connection with riskless principal transactions were important for several reasons including the accuracy of the order audit trail and the transactional integrity of the volume of last sales reported to the consolidated tape.

In view of the purpose and importance of these amendments, NASD also addressed the treatment of net trading.² Net trading is generally defined as 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. Although the difference between the execution price given to the customer in a net transaction and the price of the offsetting transaction to the contra-side (other customer or broker-dealer) is in effect the market maker's compensation, Exchange Act Rule 10b-10(a)(2)(ii)(B) does not require such compensation to be separately disclosed on the customer confirmation. In sum, net trading is the transactional equivalent of a riskless principal transaction with the exception that the prices reported on both sides of the transactions are not the same. Consequently, each side of a net transaction is trade reported at its respective price.

In view of the regulatory interest in fostering a single trade report for riskless principal transactions, NASD announced that a member "working an order" (that is, finding an offsetting execution or series of executions for a customer order that the member holds) for an institutional account or in connection with a block-size order, would be presumed to be handling the worked order on a qualifying riskless principal basis with the order matched off on each side at the same price (exclusive of any mark-up or mark-down, commission equivalent or other fee) unless the

² Id.

customer has specifically requested that the order be traded on a net basis, at a different price.³

Accordingly, NASD and Nasdaq recognized that there are times when a market maker will trade on a net basis with an institution and that such market maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price, provided that the customer has requested that the order be traded on a net basis and such arrangement satisfies the member's best execution obligation and is consistent with SEC and NASD statements regarding the matching of limit and market orders.

In response to this guidance provided by NASD and Nasdaq, members were concerned that the presumption to trade at the same price did not reflect the fact that institutional customers have historically expected firms to trade with them on a net basis. Members also were concerned that such a presumption would place them in the difficult position of having to rebut it on nearly every institutional trade. Members requested guidance on how to document this understanding, and asked for permission to use “negative consent” letters, citing difficulties with obtaining affirmative consent from customers. In response, Nasdaq, after consultation with both the SEC and NASD regulatory staff, stated that members may use negative consent letters to evidence a customer’s request to trade on a net basis, as long as the letter met specified conditions, including that the letter clearly disclosed the terms and conditions for handling the order and the customer was provided a meaningful opportunity to object to the letter.⁴

Because it has been the staff’s understanding that net trading typically only occurs at the request of institutional customers, NASD has not addressed specifically in prior Notices to

³ Id.

⁴ See SEC Release No. 34-43103 (August 1, 2000); 65 FR 48774 (August 9, 2000). See also *Notice to Members* 00-79 (November 2000).

Members a member's obligations when trading on a net basis with respect to non-institutional customers. However, given that there is a presumption that a member cannot trade on a net basis with a customer unless the customer has specifically requested it, NASD staff has taken the position that members may only trade with non-institutional customers on a net basis after obtaining their informed consent on an order-by-order basis.

To clarify and codify the staff's positions, both with respect to institutional and non-institutional customers, the proposed rule change would require a member to obtain consent from a customer prior to executing a transaction with a customer on a "net" or similar basis. Members would be required to retain and preserve all documentation relating to the consent obtained pursuant to the proposed rule in accordance with Rule 3110(a).

With respect to non-institutional customers,⁵ 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" or similar basis and such consent must evidence the customer's understanding of the terms and conditions of the order. For those non-institutional customers that have granted trading discretion to a fiduciary, such as an investment advisor, a member would be permitted to obtain such consent from the fiduciary.

With respect to institutional customers, a member also must obtain consent, but it may be evidenced through the use of a negative consent letter. If using a negative consent letter, the member must clearly disclose to the institutional customer in the letter the terms and conditions for handling the customer order(s) and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis in the letter. If no objection

⁵ For purposes of the proposed rule, "institutional customer" shall mean a customer that qualifies as an "institutional account" under Rule 3110(c)(4). A non-institutional customer, therefore, would be an account for a customer that does not qualify as an institutional account under Rule 3110(c)(4).

is received, then the member may reasonably conclude that the institutional customer has consented to the terms and conditions in the letter and requested that the member trade on a net basis and the member may rely on such letter for all of the customer's orders (unless instructed otherwise).

(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's 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. NASD believes that the proposed rule will promote investor protection by codifying the requirement that members provide disclosure and obtain customer consent when trading on a net basis.

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

Written comments were neither solicited nor received.

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.

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

BY: _____
Marc Menchel, Executive Vice President and General
Counsel
NASD, Regulatory Policy and Oversight

Date: September 1, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2004-135)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Disclosure and Consent Requirements When Trading on a Net Basis with Customers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² 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 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 filing a proposed rule to require disclosure and consent when trading on a net basis with customers. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

2441. Net Transactions with Customers

(a) Prior to executing a transaction with a customer on a “net” or similar basis as defined in paragraph (d) below, a member must provide disclosure to and obtain consent from the customer as provided in this Rule.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(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" or similar basis and such consent must evidence the customer's understanding of the terms and conditions of the order. For those non-institutional customers that have granted trading discretion to a fiduciary (e.g. an investment advisor), a member is permitted to obtain such consent from the fiduciary.

(c) With respect to institutional customers, a member may obtain customer consent through the use of a negative consent letter prior to executing a transaction for or with the customer on a "net" or similar basis. If evidencing the consent of an institutional customer through the use of a negative consent letter, before obtaining such consent, a member must clearly disclose to the institutional customer in writing the terms and conditions for handling the customer order(s) and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If no objection from the customer is received, then the member may reasonably conclude that the institutional customer has consented to the member trading on a "net" or similar basis with the customer and the member may rely on such letter for all of the customer's orders (unless instructed otherwise) pursuant to this Rule.

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(e) Members must retain and preserve all documentation relating to consent obtained pursuant to this Rule in accordance with Rule 3110(a).

* * * * *

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

A riskless principal transaction is a transaction in which a member, after having received a customer order executes an offsetting transaction, as principal, with another customer or broker-dealer to fill that customer order and both transactions are executed at the same price. NASD announced amendments to the trade reporting rules that required qualifying riskless principal transactions of market makers to be the subject of a single trade report.³ Prior to these amendments, both legs of a riskless principal transaction were reported. The amendments stipulated that a riskless principal transaction qualified for a single trade report where each side of the trade was executed at the same price, exclusive of any mark-up, mark-down, commission equivalent or other fee. The trade reporting amendments in connection with riskless principal

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transactions were important for several reasons including the accuracy of the order audit trail and the transactional integrity of the volume of last sales reported to the consolidated tape.

In view of the purpose and importance of these amendments, NASD also addressed the treatment of net trading.⁴ Net trading is generally defined as 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. Although the difference between the execution price given to the customer in a net transaction and the price of the offsetting transaction to the contra-side (other customer or broker-dealer) is in effect the market maker's compensation, Exchange Act Rule 10b-10(a)(2)(ii)(B) does not require such compensation to be separately disclosed on the customer confirmation. In sum, net trading is the transactional equivalent of a riskless principal transaction with the exception that the prices reported on both sides of the transactions are not the same. Consequently, each side of a net transaction is trade reported at its respective price.

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⁴ Id.

customer has specifically requested that the order be traded on a net basis, at a different price.⁵ Accordingly, NASD and Nasdaq recognized that there are times when a market maker will trade on a net basis with an institution and that such market maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price, provided that the customer has requested that the order be traded on a net basis and such arrangement satisfies the member's best execution obligation and is consistent with SEC and NASD statements regarding the matching of limit and market orders.

In response to this guidance provided by NASD and Nasdaq, members were concerned that the presumption to trade at the same price did not reflect the fact that institutional customers have historically expected firms to trade with them on a net basis. Members also were concerned that such a presumption would place them in the difficult position of having to rebut it on nearly every institutional trade. Members requested guidance on how to document this understanding, and asked for permission to use “negative consent” letters, citing difficulties with obtaining affirmative consent from customers. In response, Nasdaq, after consultation with both the SEC and NASD regulatory staff, stated that members may use negative consent letters to evidence a customer’s request to trade on a net basis, as long as the letter met specified conditions, including that the letter clearly disclosed the terms and conditions for handling the order and the customer was provided a meaningful opportunity to object to the letter.⁶

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is received, then the member may reasonably conclude that the institutional customer has consented to the terms and conditions in the letter and requested that the member trade on a net basis and the member may rely on such letter for all of the customer's orders (unless instructed otherwise).

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's 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. NASD believes that the proposed rule will promote investor protection by codifying the requirement that members provide disclosure and obtain customer consent when trading on a net basis.

(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

Written comments were neither solicited nor received.

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.

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. All comment letters should refer to File No. SR-NASD-2004-135. 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