

OMB APPROVAL

OMB Number: 3235-0045
Expires: June 30, 2007
Estimated average burden
hours per response.....38

Page 1 of 54

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2003 - 141
Amendment No. 2

Proposed Rule Change by National Association of Securities Dealers
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☐	Amendment ☒	Withdrawal ☐	Section 19(b)(2) ☒	Section 19(b)(3)(A) ☐	Section 19(b)(3)(B) ☐
			Rule		
Pilot ☐	Extension of Time Period for Commission Action ☐	Date Expires 	☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3)	☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document
☐

Exhibit 3 Sent As Paper Document
☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Sharon Last Name Zackula
Title Associate General Counsel
E-mail sharon.zackula@nasd.com
Telephone (202) 728-8985 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 02/17/2005

By Marc Menchel
(Name)

Executive Vice President and General Counsel

(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

MARC MENCHEL,

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EDFS website.

Form 19b-4 Information

Add

Remove

View

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

Add

Remove

View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

Add

Remove

View

Exhibit Sent As Paper Document

☐

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

Add

Remove

View

Exhibit Sent As Paper Document

☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

Add

Remove

View

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add

Remove

View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

Add

Remove

View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

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”) Amendment No. 2 to SR-NASD-2003-141, a proposed rule change to establish a second interpretation, proposed IM-2440-2, to Rule 2440. Proposed IM-2440-2 provides for additional mark-up guidance for transactions in debt securities except municipal securities. Amendment No. 2 replaces SR-NASD-2003-141 and Amendment No. 1 thereto in their entirety. Below is the text of the proposed rule change. Proposed new language is underlined; proposed 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.

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

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

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).

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.

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 proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost or proceeds are not indicative of prevailing market price, and thus overcome the presumption, in instances where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade was with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined below, and in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a "Specified Institutional Trade"). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the

dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, or where interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, the most important or first pricing factor that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, the second factor that should be taken into consideration in establishing the prevailing market prices for mark-ups (mark-downs) to customers is 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. 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, may be used in the absence of inter-dealer or institutional transactions (described in the preceding sentence) in determining prevailing market price for customer mark-ups (mark-downs).

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);

- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous 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 one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the 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.

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.

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.

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.

The degree to which a security is "similar," as that term is used in this Interpretation, 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.

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 “(sales)” and “(to)” in the phrase, “contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts,” refer to scenarios where a member is charging a customer a mark-down.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on July 30, 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 Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on July 31, 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 Board of Governors of NASD 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.

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

(a) Purpose

Introduction.

Under Rule 2440, "Fair Prices and Commissions," members are required to sell

securities to a customer at a fair price.¹ When a member acts in a principal capacity and sells a security to a customer, a dealer generally “marks up” the security, increasing the total price the customer pays. Conversely, when buying a security from a customer, a dealer that is a principal generally “marks down” the security, reducing the total proceeds the customer receives. IM-2440, “Mark-Up Policy,” provides additional guidance on mark-ups and fair pricing of securities transactions with customers.² Both Rule 2440 and IM-2440 apply to transactions in debt securities and IM-2440 provides that mark-ups for transactions in debt securities are customarily lower than those for common stock transactions.³

Under Rule 2440 and IM-2440, when a customer buys a security from a dealer, the customer’s total purchase price, and the mark-up included in the price, must be fair and reasonable. Similarly, when a customer sells a security to a dealer, the customer’s total proceeds from the sale, which were reduced by the mark-down, and the mark-down, must be fair and reasonable. A key step in determining whether a mark-up (mark-down)

¹ Rule 2440 specifically provides that a member is required to sell a security at a fair price to customers, “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 . . .” Rule 2320, “Best Execution and Interpositioning,” also addresses a member’s obligation in pricing customer transactions. In any transaction for or with a customer, Rule 2320 requires a member to “use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy and sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.” Together, Rule 2440 and Rule 2320 impose broad responsibilities on broker-dealers to price customer transactions fairly. Cf. “Review of Dealer Pricing Responsibilities,” MSRB Notice 2004 – 3 (January 26, 2004).

² The terms “mark-up” and “mark-down” are not found in Rule 2440, but are used in IM-2440. Statements regarding mark-ups also apply generally to mark-downs unless mark-downs are discussed specifically in a separate statement.

³ IM-2440(b)(1).

is fair and reasonable is correctly identifying the *prevailing market price* of the security, which is the basis from which the mark-up (mark-down) is calculated.

The proposed interpretation, “IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities” (“Proposed Interpretation”), provides additional guidance on mark-ups (mark-downs) in debt securities transactions, except municipal securities transactions.⁴ The Proposed Interpretation addresses two fundamental issues in debt securities transactions: (1) how does a dealer correctly identify the prevailing market price of a debt security; and (2) what is a “similar” security and when may it be considered in determining the prevailing market price.

⁴ Municipal Securities Rulemaking Board (MSRB) Rule G-30, “Prices and Commissions,” applies to transactions in municipal securities, and requires that a municipal securities dealer engaging in a transaction as a principal with a customer must buy or sell securities at an aggregate price that is “fair and reasonable.”

Prevailing Market Price.

The Proposed Interpretation provides that when a dealer calculates a mark-up (or mark-down), the best measure of the prevailing market price of the security is presumptively the dealer's contemporaneous cost (proceeds).⁵ Further, the dealer may look to countervailing evidence of the prevailing market price *only* where the dealer, when selling a security, 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 buying a security from a customer, the dealer may look to countervailing evidence of the prevailing market price *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.

The statement that a dealer's contemporaneous cost is presumptively the prevailing market price of a security is a restatement of a fundamental principle found in existing law in court cases and SEC and NASD decisions regarding mark-ups. The presumption that contemporaneous cost is the best evidence of prevailing market price is found in many cases, and its specific applicability to debt securities transactions was

⁵ Of course, if a dealer violates Rule 2320, the dealer's contemporaneous cost (proceeds) in such transactions would not be a reliable indicator of the prevailing market price for the purpose of determining a mark-up or mark-down. If a dealer violates Rule 2320 because the dealer fails to exercise diligence, fails to negotiate at arms length in the market, or engages in fraudulent transactions, including those entered into in collusion with other dealers or brokers, including inter-dealer brokers, the price that the dealer obtains is not a price reflecting market forces, and, therefore, is not a valid indicator of the prevailing market price and should not be used to calculate a mark-up (mark-down). In addition, if a dealer that is not a party to a transaction engages in conduct to improperly influence the pricing of such transaction, the dealer could not properly use the execution price as the basis from which to compute a mark-up (mark-down) because the execution price does not represent the prevailing market price of the security.

addressed by the SEC as early as 1992 in F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993) ("F.B. Horner"), a debt mark-up case. In F. B. Horner, the SEC stated: "We have consistently held that where, as in the present case, a dealer is not a market maker, the best evidence of the current market, absent countervailing evidence, is the dealer's contemporaneous cost." F.B. Horner, 50 S.E.C. at 1065-66. The basis for the standard was also restated. "That standard, which has received judicial approval, reflects the fact that the prices paid for a security by a dealer in transactions closely related in time to his retail sales are normally a highly reliable indication of the prevailing market." F.B. Horner, 50 S.E.C. at 1066. The Proposed Interpretation contemplates that for a dealer to be deemed a market maker in a debt security, the dealer must meet the legal requirements for market maker status, as provided in Section 3(a)(38) of the Act.⁶

The Proposed Interpretation recognizes that in some circumstances a dealer may seek to overcome the presumption that the dealer's own contemporaneous cost (proceeds) are the prevailing market price of the subject security for determining a mark-up (mark-down), and sets forth a process for identifying a value other than the dealer's own contemporaneous cost (proceeds) as the prevailing market price.

A dealer may seek to overcome the presumption that its contemporaneous cost or proceeds are not indicative of the prevailing market price in instances when the dealer establishes that the dealer's contemporaneous trade was a "Specified Institutional Trade." A "Specified Institutional Trade" is defined as a dealer's contemporaneous trade with an

⁶ 15 U.S.C. 78c(a)(38).

institutional account with which the dealer regularly effects transactions in the same or a “similar” security, as defined below, and in the case of a sale to such an account, the trade was executed at a price *higher* than the then prevailing market price, and in the case of a purchase from such an account, the trade was executed at a price *lower* than the then prevailing market price, *and* the execution price was away from the prevailing market price because of the size and risk of the transaction. In cases where the dealer asserts that its contemporaneous trade was a “Specified Institutional Trade,” in order to overcome the presumption that the dealer’s contemporaneous cost (or proceeds) is the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price in the subject security by referring *exclusively* to inter-dealer trades in the same security executed contemporaneously with the dealer’s Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer’s contemporaneous cost (proceeds) provide the best measure of the prevailing market price, or where interest rates or credit quality of the security changed significantly, the dealer must follow a process for determining prevailing market price, considering certain factors in the appropriate order, as set forth in the Proposed Interpretation. Initially, a dealer must look to three factors or measures in the order they are presented (the “Hierarchy”) to determine prevailing market price. The most important and first factor in the Hierarchy is the pricing of any contemporaneous inter-dealer transactions in the same security. The second most important factor in the Hierarchy recognizes the role of certain large institutions in the fixed income securities

markets. In the absence of inter-dealer transactions, the second factor a dealer must consider is the prices of contemporaneous dealer purchases in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security. (Contemporaneous dealer sales with such institutional accounts would be used to calculate a mark-down.)⁷ If contemporaneous inter-dealer trades or dealer-institutional trades in the same security are not available, a dealer must look to the third factor in the Hierarchy, which may be applied only to actively-traded securities. For actively traded securities, a dealer is required to look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if such quotations are made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.⁸

If none of the three factors in the Hierarchy is available, the dealer then may take into consideration the non-exclusive list of four factors in the Proposed Interpretation in trying to establish prevailing market price using a measure other than the dealer's contemporaneous cost (proceeds). In contrast to the Hierarchy of three factors discussed above, a dealer is not required to consider the four factors below in a particular order.

⁷ If a dealer has overcome the presumption by establishing that interest rates or the credit quality of the security changed significantly after the dealer's trade, any inter-dealer or dealer-institutional trades in the same security *that occurred prior to the event* would not be valid measures of the prevailing market price as such transactions would be subject to the same imperfection.

⁸ A dealer also is subject to the process of establishing prevailing market price, including the analysis under the Hierarchy and the other factors discussed below, where the dealer has not engaged in trading in the subject security for an extended period and therefore can evidence that it has no contemporaneous cost (proceeds) to refer to as a basis for computing a mark-up (mark-down).

The four factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

- 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);
- Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” securities;
- Yields calculated from prices of contemporaneous 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).

When applying one or more of the four factors, a dealer must consider that the ultimate evidentiary issue is whether the prevailing market price of the security will be correctly identified. As stated in the Proposed Interpretation, the relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the final factor, the relative spread of the quotations in the “similar” security to the quotations in the subject security.

Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, a member may consider as a factor in determining the prevailing market price the prices or yields derived from economic 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). However, dealers may not use any economic model to establish the prevailing market price for mark-up (mark-down) purposes, except in limited instances where none of the three factors in the Hierarchy apply, the subject security is infrequently traded, and the security is of such low credit quality (e.g., a distressed debt security) that a dealer cannot identify a “similar” security.⁹

The final principle in the Proposed Interpretation regarding prevailing market price addresses the use of pricing information from isolated transactions or quotations. The Proposed Interpretation provides that “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

⁹ When a dealer seeks to identify prevailing market price using other than the dealer’s contemporaneous cost or contemporaneous proceeds, the dealer must be prepared to provide evidence that will establish the dealer’s basis for not using contemporaneous cost (proceeds), and information about the other values reviewed (e.g., the specific prices and/or yields of securities that were identified as similar securities) in order to determine the prevailing market price of the subject security. If a firm relies upon pricing information from a model the firm uses or has developed, the firm must be able to provide information that was used on the day of the transaction to develop the pricing information (i.e., the data that was input, and the data that the model generated and the firm used to arrive at prevailing market price).

number of transactions that are not fairly representative of the yields of transactions in ‘similar’ securities taken as a whole.”

“Similar” Securities.

The second fundamental issue addressed in the Proposed Interpretation is what is a “similar” security. Several of the factors referenced above to which a dealer may refer when determining the prevailing market price as a value that is other than the dealer’s contemporaneous cost (proceeds) require a dealer to identify one or more “similar” securities. The definition of “similar” security, and the uses and limitations of “similar” securities are the second part of the Proposed Interpretation.

The Proposed Interpretation provides that a “similar” security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment. In addition, at a minimum, a dealer must be able to fairly estimate the market yield for the subject security from the yields of “similar” securities. Finally, to aid members in identifying “similar” securities when appropriate, the Proposed Interpretation sets forth a list of non-exclusive factors to determine the similarity between the subject security and one or more other securities. The non-exclusive list of factors that can be used to assess similarity includes 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 that 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 in 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 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.

The Proposed Interpretation also states that, for certain securities, there are no “similar” securities. Specifically, when a debt security’s value and pricing is based substantially, and is highly dependent, on the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to make interest payments and otherwise meet the specific obligations of the security, in most cases other securities will not be sufficiently “similar,” and therefore, may not be used to establish prevailing market price of the subject security. As noted above, NASD may consider a dealer’s pricing information obtained from an economic model to establish prevailing market price, when “similar” securities do not exist and facts and circumstances have combined to create a price information void in the subject security.¹⁰

¹⁰ In addition, as provided in the Proposed Interpretation, NASD also may look to economic models other than the dealer’s to make determinations as to the prevailing market price of a security.

The provisions regarding “similar” securities, if adopted, would affirm explicitly, for the first time, that it may be appropriate under specified circumstances to refer to “similar” securities to determine prevailing market price. In addition, the Proposed Interpretation provides guidance as to the degree of similarity that is required. Also, the Proposed Interpretation recognizes an additional source of pricing information, i.e., certain economic models, that a dealer may consider in determining prevailing market price when all other factors, including those employing “similar securities,” do not render relevant pricing information because transactions and quotes (that have been validated by active trading) have not occurred in the subject security and there are no “similar” securities. Thus, when all other factors have been considered but are irrelevant, such as when a very distressed, very illiquid security is traded, the Proposed Interpretation provides the flexibility to determine prevailing market price and an appropriate mark-up (mark-down).

Conclusion.

NASD believes that the Proposed Interpretation recognizes the special characteristics of debt instruments, reflects the particular nature of trading in the debt markets, and provides important guidance to all members engaged in debt securities transactions on two issues. First, the guidance sets forth clearly a basic principle in NASD’s rules: a dealer’s contemporaneous cost (or, when calculating a mark-down, a dealer’s contemporaneous proceeds) is presumptively the prevailing market price in debt securities transactions. The Proposed Interpretation also provides guidance on when this principle may not be applicable, and, in those cases, guidance on the dealer’s obligation to provide evidence of the prevailing market price using the factors set forth above, and,

as applicable, in the priority set forth above, and any other relevant evidence of prevailing market price. Importantly, NASD also proposes to recognize, in limited circumstances, that a dealer may refer to an economic model to provide evidence of the prevailing market price of a security when the security is sufficiently illiquid that the debt market does not provide evidence of the prevailing market price, and the security does not meet other criteria and therefore cannot be compared with a “similar” security.

Second, the Proposed Interpretation announces explicitly that a dealer is permitted to use “similar” securities in some cases where the dealer is identifying the prevailing market price of a security using a measure other than the dealer’s contemporaneous cost (or contemporaneous proceeds). NASD’s recognition of the limited but appropriate use of a “similar” security includes guidance on which securities may be considered “similar” securities. NASD believes that the Proposed Interpretation is an important first step in developing additional mark-up guidance for members engaged in debt securities transactions with customers on a principal basis.

As noted in Item 2 of this filing, 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) 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. NASD believes that clarifying the standard for correctly identifying the prevailing market price of a debt security for purposes of calculating a mark-up (mark-down), clarifying the additional obligations of a member when it seeks to use a measure other than the member's own contemporaneous cost (proceeds) as the prevailing market price, and confirming that similar securities may be used in certain instances to determine the prevailing market price are measures designed to prevent fraudulent practices, promote just and equitable principles of trade, and protect investors and the public interest.

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

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

Exhibit 4. Text of proposed rule change marked to show changes from Amendment No. 1 to Amendment No. 2.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2003-141)

SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc.
Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except
Municipal Securities

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 September 16, 2003, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) and amended on June 29, 2004 and February XX, 2005,³ 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 adopt a second interpretation, proposed IM-2440-2, to Rule 2440 to provide additional mark-up guidance for transactions in debt securities except

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 to SR-NASD-2003-141, filed on June 29, 2004, made substantive and technical changes to the original rule filing. Amendment No. 2 to SR-NASD-2003-141, filed on June 29, 2004, replaced and superseded the original rule filing.

municipal securities. Below is the text of the proposed rule change. Proposed new language is in italics; proposed 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.

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

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

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).

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.

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 proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous

cost or proceeds are not indicative of prevailing market price, and thus overcome the presumption, in instances where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade was with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined below, and in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a "Specified Institutional Trade"). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, or where interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, the most important or first pricing factor that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, the second factor that should be taken into consideration in establishing the prevailing market prices for mark-

ups (mark-downs) to customers is 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. 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, may be used in the absence of inter-dealer or institutional transactions (described in the preceding sentence) in determining prevailing market price for customer mark-ups (mark-downs).

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);
- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous 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 one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the 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.

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.

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.

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.

The degree to which a security is "similar," as that term is used in this Interpretation, 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.

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 "(sales)" and "(to)" in the phrase, "contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts," refer to scenarios where a member is charging a customer a mark-down.

* * * * *

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

Introduction.

Under Rule 2440, “Fair Prices and Commissions,” members are required to sell securities to a customer at a fair price.⁴ When a member acts in a principal capacity and sells a security to a customer, a dealer generally “marks up” the security, increasing the total price the customer pays. Conversely, when buying a security from a customer, a dealer that is a principal generally “marks down” the security, reducing the total proceeds the customer receives. IM-2440, “Mark-Up Policy,” provides additional guidance on mark-ups and fair pricing of securities transactions with customers.⁵ Both Rule 2440 and IM-2440 apply to transactions in debt securities and IM-2440 provides that mark-ups for transactions in debt securities are customarily lower than those for common stock transactions.⁶

Under Rule 2440 and IM-2440, when a customer buys a security from a dealer, the customer’s total purchase price, and the mark-up included in the price, must be fair

⁴ Rule 2440 specifically provides that a member is required to sell a security at a fair price to customers, “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 . . .” Rule 2320, “Best Execution and Interpositioning,” also addresses a member’s obligation in pricing customer transactions. In any transaction for or with a customer, Rule 2320 requires a member to “use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy and sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.” Together, Rule 2440 and Rule 2320 impose broad responsibilities on broker-dealers to price customer transactions fairly. Cf. “Review of Dealer Pricing Responsibilities,” MSRB Notice 2004 – 3 (January 26, 2004).

⁵ The terms “mark-up” and “mark-down” are not found in Rule 2440, but are used in IM-2440. Statements regarding mark-ups also apply generally to mark-downs unless mark-downs are discussed specifically in a separate statement.

⁶ IM-2440(b)(1).

and reasonable. Similarly, when a customer sells a security to a dealer, the customer's total proceeds from the sale, which were reduced by the mark-down, and the mark-down, must be fair and reasonable. A key step in determining whether a mark-up (mark-down) is fair and reasonable is correctly identifying the *prevailing market price* of the security, which is the basis from which the mark-up (mark-down) is calculated.

The proposed interpretation, "IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities" ("Proposed Interpretation"), provides additional guidance on mark-ups (mark-downs) in debt securities transactions, except municipal securities transactions.⁷ The Proposed Interpretation addresses two fundamental issues in debt securities transactions: (1) how does a dealer correctly identify the prevailing market price of a debt security; and (2) what is a "similar" security and when may it be considered in determining the prevailing market price.

⁷

Municipal Securities Rulemaking Board (MSRB) Rule G-30, "Prices and Commissions," applies to transactions in municipal securities, and requires that a municipal securities dealer engaging in a transaction as a principal with a customer must buy or sell securities at an aggregate price that is "fair and reasonable."

Prevailing Market Price.

The Proposed Interpretation provides that when a dealer calculates a mark-up (or mark-down), the best measure of the prevailing market price of the security is presumptively the dealer's contemporaneous cost (proceeds).⁸ Further, the dealer may look to countervailing evidence of the prevailing market price *only* where the dealer, when selling a security, 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 buying a security from a customer, the dealer may look to countervailing evidence of the prevailing market price *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.

The statement that a dealer's contemporaneous cost is presumptively the prevailing market price of a security is a restatement of a fundamental principle found in existing law in court cases and SEC and NASD decisions regarding mark-ups. The presumption that contemporaneous cost is the best evidence of prevailing market price is found in many cases, and its specific applicability to debt securities transactions was

⁸ Of course, if a dealer violates Rule 2320, the dealer's contemporaneous cost (proceeds) in such transactions would not be a reliable indicator of the prevailing market price for the purpose of determining a mark-up or mark-down. If a dealer violates Rule 2320 because the dealer fails to exercise diligence, fails to negotiate at arms length in the market, or engages in fraudulent transactions, including those entered into in collusion with other dealers or brokers, including inter-dealer brokers, the price that the dealer obtains is not a price reflecting market forces, and, therefore, is not a valid indicator of the prevailing market price and should not be used to calculate a mark-up (mark-down). In addition, if a dealer that is not a party to a transaction engages in conduct to improperly influence the pricing of such transaction, the dealer could not properly use the execution price as the basis from which to compute a mark-up (mark-down) because the execution price does not represent the prevailing market price of the security.

addressed by the SEC as early as 1992 in F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993) ("F.B. Horner"), a debt mark-up case. In F. B. Horner, the SEC stated: "We have consistently held that where, as in the present case, a dealer is not a market maker, the best evidence of the current market, absent countervailing evidence, is the dealer's contemporaneous cost." F.B. Horner, 50 S.E.C. at 1065-66. The basis for the standard was also restated. "That standard, which has received judicial approval, reflects the fact that the prices paid for a security by a dealer in transactions closely related in time to his retail sales are normally a highly reliable indication of the prevailing market." F.B. Horner, 50 S.E.C. at 1066. The Proposed Interpretation contemplates that for a dealer to be deemed a market maker in a debt security, the dealer must meet the legal requirements for market maker status, as provided in Section 3(a)(38) of the Act.⁹

The Proposed Interpretation recognizes that in some circumstances a dealer may seek to overcome the presumption that the dealer's own contemporaneous cost (proceeds) are the prevailing market price of the subject security for determining a mark-up (mark-down), and sets forth a process for identifying a value other than the dealer's own contemporaneous cost (proceeds).

A dealer may seek to overcome the presumption that its contemporaneous cost or proceeds are not indicative of the prevailing market price in instances when the dealer establishes that the dealer's contemporaneous trade was a "Specified Institutional Trade." A "Specified Institutional Trade" is defined as a dealer's contemporaneous trade with an institutional account with which the dealer regularly effects transactions in the same or a

⁹ 15 U.S.C. 78c(a)(38).

“similar” security, as defined below, and in the case of a sale to such an account, the trade was executed at a price *higher* than the then prevailing market price, and in the case of a purchase from such an account, the trade was executed at a price *lower* than the then prevailing market price, *and* the execution price was away from the prevailing market price because of the size and risk of the transaction. In cases where the dealer asserts that its contemporaneous trade was a “Specified Institutional Trade,” in order to overcome the presumption that the dealer’s contemporaneous cost (or proceeds) is the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price in the subject security by referring *exclusively* to inter-dealer trades in the same security executed contemporaneously with the dealer’s Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer’s contemporaneous cost (proceeds) provide the best measure of the prevailing market price, or where interest rates or credit quality of the security changed significantly, the dealer must follow a process for determining prevailing market price, considering certain factors in the appropriate order, as set forth in the Proposed Interpretation. Initially, a dealer must look to three factors or measures in the order they are presented (the “Hierarchy”) to determine prevailing market price. The most important and first factor in the Hierarchy is the pricing of any contemporaneous inter-dealer transactions in the same security. The second most important factor in the Hierarchy recognizes the role of certain large institutions in the fixed income securities markets. In the absence of inter-dealer transactions, the second factor a dealer must

consider is the prices of contemporaneous dealer purchases in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security. (Contemporaneous dealer sales with such institutional accounts would be used to calculate a mark-down.)¹⁰ If contemporaneous inter-dealer trades or dealer-institutional trades in the same security are not available, a dealer must look to the third factor in the Hierarchy, which may be applied only to actively-traded securities. For actively traded securities, a dealer is required to look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if such quotations are made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.¹¹

If none of the three factors in the Hierarchy is available, the dealer then may take into consideration the non-exclusive list of four factors in the Proposed Interpretation in trying to establish prevailing market price using a measure other than the dealer's contemporaneous cost (proceeds). In contrast to the Hierarchy of three factors discussed above, a dealer is not required to consider the four factors below in a particular order. The four factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

¹⁰ If a dealer has overcome the presumption by establishing that interest rates or the credit quality of the security changed significantly after the dealer's trade, any inter-dealer or dealer-institutional trades in the same security *that occurred prior to the event* would not be valid measures of the prevailing market price as such transactions would be subject to the same imperfection.

¹¹ A dealer also is subject to the process of establishing prevailing market price, including the analysis under the Hierarchy and the other factors discussed below, where the dealer has not engaged in trading in the subject security for an extended period and therefore can evidence that it has no contemporaneous cost (proceeds) to refer to as a basis for computing a mark-up (mark-down).

- 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);
- Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” securities;
- Yields calculated from prices of contemporaneous 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).

When applying one or more of the four factors, a dealer must consider that the ultimate evidentiary issue is whether the prevailing market price of the security will be correctly identified. As stated in the Proposed Interpretation, the relative weight one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the timeliness of the information, and, with respect to the final factor, the relative spread of the quotations in the “similar” security to the quotations in the subject security.

Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, a member may consider as a factor in determining the prevailing market price the prices or yields derived from

economic 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). However, dealers may not use any economic model to establish the prevailing market price for mark-up (mark-down) purposes, except in limited instances where none of the three factors in the Hierarchy apply, the subject security is infrequently traded, and the security is of such low credit quality (e.g., a distressed debt security) that a dealer cannot identify a “similar” security.¹²

The final principle in the Proposed Interpretation regarding prevailing market price addresses the use of pricing information from isolated transactions or quotations. The Proposed Interpretation provides that “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.”

“Similar” Securities.

The second fundamental issue addressed in the Proposed Interpretation is what is a “similar” security. Several of the factors referenced above to which a dealer may refer

¹² When a dealer seeks to identify prevailing market price using other than the dealer’s contemporaneous cost or contemporaneous proceeds, the dealer must be prepared to provide evidence that will establish the dealer’s basis for not using contemporaneous cost (proceeds), and information about the other values reviewed (e.g., the specific prices and/or yields of securities that were identified as similar securities) in order to determine the prevailing market price of the subject security. If a firm relies upon pricing information from a model the firm uses or has developed, the firm must be able to provide information that was used on the day of the transaction to develop the pricing information (i.e., the data that was input, and the data that the model generated and the firm used to arrive at prevailing market price).

when determining the prevailing market price as a value that is other than the dealer's contemporaneous cost (proceeds) require a dealer to identify one or more "similar" securities. The definition of "similar" security, and the uses and limitations of "similar" securities are the second part of the Proposed Interpretation.

The Proposed Interpretation provides that a "similar" security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment. In addition, at a minimum, a dealer must be able to fairly estimate the market yield for the subject security from the yields of "similar" securities. Finally, to aid members in identifying "similar" securities when appropriate, the Proposed Interpretation sets forth a list of non-exclusive factors to determine the similarity between the subject security and one or more other securities. The non-exclusive list of factors that can be used to assess similarity includes 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 that 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 in 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 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.

The Proposed Interpretation also states that, for certain securities, there are no “similar” securities. Specifically, when a debt security’s value and pricing is based substantially, and is highly dependent, on the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to make interest payments and otherwise meet the specific obligations of the security, in most cases other securities will not be sufficiently “similar,” and therefore, may not be used to establish prevailing market price of the subject security. As noted above, NASD may consider a dealer’s pricing information obtained from an economic model to establish prevailing market price, when “similar” securities do not exist and facts and circumstances have combined to create a price information void in the subject security.¹³

The provisions regarding “similar” securities, if adopted, would affirm explicitly, for the first time, that it may be appropriate under specified circumstances to refer to “similar” securities to determine prevailing market price. In addition, the Proposed Interpretation provides guidance as to the degree of similarity that is required. Also, the Proposed Interpretation recognizes an additional source of pricing information, i.e., certain economic models, that a dealer may consider in determining prevailing market

¹³ In addition, as provided in the Proposed Interpretation, NASD also may look to economic models other than the dealer’s to make determinations as to the prevailing market price of a security.

price when all other factors, including those employing “similar securities,” do not render relevant pricing information because transactions and quotes (that have been validated by active trading) have not occurred in the subject security and there are no “similar” securities. Thus, when all other factors have been considered but are irrelevant, such as when a very distressed, very illiquid security is traded, the Proposed Interpretation provides the flexibility to determine prevailing market price and an appropriate mark-up (mark-down).

Conclusion.

NASD believes that the Proposed Interpretation recognizes the special characteristics of debt instruments, reflects the particular nature of trading in the debt markets, and provides important guidance to all members engaged in debt securities transactions on two issues. First, the guidance sets forth clearly a basic principle in NASD’s rules: a dealer’s contemporaneous cost (or, when calculating a mark-down, a dealer’s contemporaneous proceeds) is presumptively the prevailing market price in debt securities transactions. The Proposed Interpretation also provides guidance on when this principle may not be applicable, and, in those cases, guidance on the dealer’s obligation to provide evidence of the prevailing market price using the factors set forth above, and, as applicable, in the priority set forth above, and any other relevant evidence of prevailing market price. Importantly, NASD also proposes to recognize, in limited circumstances, that a dealer may refer to an economic model to provide evidence of the prevailing market price of a security when the security is sufficiently illiquid that the debt market does not provide evidence of the prevailing market price, and the security does not meet other criteria and therefore cannot be compared with a “similar” security.

Second, the Proposed Interpretation announces explicitly that a dealer is permitted to use “similar” securities in some cases where the dealer is identifying the prevailing market price of a security using a measure other than the dealer’s contemporaneous cost (or contemporaneous proceeds). NASD’s recognition of the limited but appropriate use of a “similar” security includes guidance on which securities may be considered “similar” securities. NASD believes that the Proposed Interpretation is an important first step in developing additional mark-up guidance for members engaged in debt securities transactions with customers on a principal basis.

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.

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 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 clarifying the standard for correctly identifying the prevailing market price of a debt security for purposes of calculating a mark-up (mark-down), clarifying the additional obligations of a member when it seeks to use a measure other than the member’s own contemporaneous cost (proceeds) as the prevailing market price, and confirming that similar securities may be used in certain instances to determine the prevailing market price are measures designed to prevent fraudulent practices,

promote just and equitable principles of trade, and protect investors and the public interest.

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. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2003-141 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2003-141. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the

File Number SR-NASD-2003-141 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Secretary

¹⁴ 17 CFR 200.30-3(a)(12).

EXHIBIT 4

SR-NASD-2003-141: Text of proposed rule change marked to show changes from Amendment No. 1 to Amendment No. 2, with the language in the initial rule filing and Amendment No. 1 shown as if adopted, and the new language marked to show additions and deletions.

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.

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

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

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).

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.

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 proceeds must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost or proceeds are not indicative of prevailing market price, and thus overcome the

presumption, in instances [such as]where (i) interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, or (ii) the dealer's contemporaneous trade was with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined below, and in the case of a sale to such account, was executed at a price higher than the then prevailing market price, or, in the case of a purchase from such account, was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction (a "Specified Institutional Trade"). In the case of a Specified Institutional Trade, when a dealer seeks to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, the dealer must provide evidence of the then prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's Specified Institutional Trade.

In instances other than those pertaining to a Specified Institutional Trade, where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost or proceeds provide the best measure of the prevailing market price, [such as]or where interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades, the most important[benchmark] or first pricing factor that should be taken into consideration in establishing prevailing market price for a mark-up or a mark-down is prices of any contemporaneous inter-dealer transactions in the security in question. In the absence of inter-dealer transactions, the second factor that should be taken into consideration in establishing the prevailing market prices for mark-ups (mark-downs) to customers is 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, [may be used in establishing the prevailing market prices for mark-ups (mark-downs) to customers.] 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, may be used in the absence of inter-dealer or institutional transactions (described in the preceding sentence) in determining prevailing market price for customer mark-ups (mark-downs).

In the event that, in particular circumstances, the above [benchmarks] 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);
- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous 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 one may attribute to these other factors depends on the facts and circumstances surrounding the comparison transaction, such as its size, whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, the 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.

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.

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.

A "similar" security should be sufficiently similar to the subject security [under review] 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 [under review] 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.

The degree to which a security is "similar," as that term is used in this Interpretation, to the subject security may be determined by factors that include but are not limited to the following:

(a)[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)[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)[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)[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.

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 [i]Interpretation does not apply to transactions in municipal securities.[The singular and plural forms of the terms,“(sales),”“(mark-down),” and“(offer),” refer to factors members will use to calculate or charge a customer a mark-down.] Single terms in parentheses within sentences, such as the terms“(sales)” and“(to)” in the phrase, “contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts,” refer to scenarios where a member is charging a customer a mark-down.