

OMB APPROVAL

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

File No. SR - 2004 - 026
 Amendment No. 3

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)(4)	
			☐ 19b-4(f)(2)	☐ 19b-4(f)(5)	
			☐ 19b-4(f)(3)	☐ 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document
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Exhibit 3 Sent As Paper Document
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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 Kathleen Last Name O'Mara
 Title Associate General Counsel
 E-mail kathleen.omara@nasd.com
 Telephone (202) 728-8056 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 06/22/2005

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 EFFT website.

Form 19b-4 Information

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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

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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

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Exhibit Sent As Paper Document

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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

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Exhibit Sent As Paper Document

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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

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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

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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

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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. 3 to SR-NASD-2004-026, which proposes a rule change to NASD Rule 2320(a) (“Best Execution Rule”). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

- (1) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
- (2) the size and type of transaction;
- (3) the number of [primary] markets checked;
- (4) accessibility of the quotation [location and accessibility to the customer’s broker/dealer of primary markets and quotations sources.]; and

(5) the terms and conditions of the order which result in the transaction,
as communicated to the member and persons associated with the member.

(b) through (g) No change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was originally approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 12, 2003, which authorized the filing of the rule change with the SEC. The NASD Board of Governors reviewed the proposed rule change originally at its meeting on November 13, 2003. This amendment to the proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 17, 2004, which authorized the filing of the amendment with the SEC. The NASD Board of Governors reviewed the amendment to the proposed rule change at its meeting on November 18, 2004. 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. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

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

effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

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

(a) Purpose

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. NASD has received a number of questions regarding the application of the term “customer” in the context of best execution. Rule 0120(g) defines “customer” to exclude a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer (“originating broker-dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could argue that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker-dealer.

NASD believes that not applying the Best Execution Rule to recipient members is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker-dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice. The

majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.

On February 11, 2004, NASD submitted to the SEC rule filing SR-NASD-2004-026 requiring that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. The proposal also sought to clarify that the recipient member was not required to enter into any such written agreements with the originating broker-dealer, and that the originating broker-dealer (to the extent it is was a member) would remain obligated to comply with the Best Execution Rule, irrespective of whether such an agreement existed.

On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing. Amendment No. 1 continued to require that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. In addition, Amendment No. 1 added a new reasonable diligence factor to the text of the Best Execution Rule that required consideration of the existence of a written agreement or written representations when a customer order is routed to another broker-dealer. Also, the amendment modified the text of new proposed paragraph (a)(2) of the Best Execution Rule. Lastly, the amendment provided proposed interpretive guidance

concerning Rule 2320, as amended.

On February 14, 2005, NASD submitted to the SEC Amendment No. 2 to SR-NASD-2004-026, which required that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer without regard to whether a customer order is executed by the originating broker-dealer or routed to another broker-dealer.¹ Amendment No. 2 also proposed changes to modernize the text of the rule. Specifically, NASD proposed an amendment to clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all market centers in which a security is traded. In addition, Amendment No. 2 amended the reasonable diligence factors to reflect current market structure and to delete outdated terms. In particular, NASD proposed amending the reference to the “number of primary markets checked” to instead refer to “the number of market centers checked.” Amendment No. 2 also added a new factor that examines the “terms and conditions of the order” in determining whether a member has used due diligence.

Proposal

Today, NASD is filing Amendment 3, which deletes proposed references to market centers and simply uses the term “market.” NASD is making this change in response to comments that suggest that the term “market center” would: 1) create an unfair competitive disparity in the equity market; and 2) create confusion and problems of interpretation, application, and enforcement in the debt market. While the term “market” has been in the text of Rule 2320 since its adoption, it is an undefined term.

¹ NASD staff continues to believe this approach is preferable to that specified in the original rule proposal and Amendment No. 1 because customer orders will

Accordingly, NASD is providing interpretive guidance that states that, for purposes of Rule 2320, the term “market” or “markets” should be interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of best execution.

NASD also is providing interpretive guidance concerning how the Best Execution Rule should be applied in the debt market with respect to the “accessibility of the quotations” reasonable diligence factor. When quotations are available, such as for certain liquid debt securities, NASD will consider the “accessibility of such quotations” when examining whether a member has used due diligence. For purposes of debt, the term “quotation” refers to either dollar (or other currency) pricing or yield pricing.²

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.

receive best execution protections without regard to whether there is a written agreement or written representations from a recipient member.

² NASD notes, however, that accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule 2320. In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets, and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

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

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

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

On February 25, 2005, the SEC published SR-NASD-2004-026 for public comment in the Federal Register.³ The SEC received three comment letters in response to the publication of the rule proposal in the Federal Register.⁴

³ Securities Exchange Act Rel. No. 51229 (February 18, 2005), 70 FR 9416 (February 25, 2005) (Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2).

⁴ Letter from The Ad Hoc Best Execution Committee of the Securities Industry Association dated March 18, 2005; letter from Instinet Group Incorporated dated

The Bond Market Association (BMA) submitted a comment letter stating, among other things, its belief that NASD only considered equities trading when drafting the proposed rule change.⁵ Specifically, BMA states that NASD's proposed change of terminology in an attempt to clarify and modernize the Best Execution Rule exemplifies how the rule change was drafted to address equities trading only and states further that changing "inter-dealer" markets to "market centers" has no meaning in the context of the bond market. BMA believes the proposal is inappropriate for fixed income securities and, if adopted, would exacerbate existing difficulties with regard to bond trading. In addition, BMA believes applying the Best Execution Rule, as amended, is impractical, unfair, anti-competitive, unworkable in the case of the bond market, and inconsistent with a customer's reasonable expectations of how its orders will be handled.

NASD appreciates the comments of BMA but does not find them to be persuasive. Essentially, BMA is advocating, for a number of reasons, that the Best Execution Rule is not applicable to the debt market. However, the terms of Rule 2320 have never been limited to equity securities and the consistency of this observation is expressed in Rule 0116 in which the Best Execution Rule, among others, is made

March 22, 2005; and letter from The Bond Market Association dated April 5, 2005.

⁵ NASD did not intend to only consider equity trading when drafting this proposal. In this rule proposal, NASD is again clarifying that the Best Execution Rule is applicable to the debt market, and is providing additional interpretive guidance. Specifically, NASD is providing interpretive guidance with respect to the "accessibility of the quotations" reasonable diligence factor and the application of this factor in the debt market. When quotations are available, such as for certain liquid debt securities, NASD will consider the "accessibility of such quotations" when examining whether a member has used due diligence. In such instances, the term "quotation" refers to either dollar (or other currency) pricing or yield pricing.

applicable to transactions and business activities relating to exempted securities (other than municipal securities) conducted by members and associated persons.⁶

Further, BMA asserts that the term “market center” is an equity term and cannot be applied in the context of debt. We acknowledge that the term “market center” has traditionally been used in connection with certain equity securities. For example, SEC Rule 11Ac1-5(a)(14), which is applicable to national market system securities, defined “market center” as any exchange market maker, over-the-counter (OTC) market maker, alternative trading system, national securities exchange, or national securities association. In seeking to modernize the Best Execution Rule, NASD sought a recognized term that was aimed broadly at capturing order execution venues. However, in response to comments, including BMA’s concerns that use of this term may introduce confusion in the debt market, NASD has determined to amend the Best Execution Rule to instead use the term “market.” It should be noted, as discussed above, that the term “market” or “markets” for purposes of Rule 2320, should be interpreted broadly to include a variety of different venues, including but not limited to market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge; it is not NASD’s intention to mandate that certain trading venues have less relevance than others in the course of best execution.

⁶ See Securities Exchange Act Rel. No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Approval of SR-NASD-2000-38).

BMA also believes imposing a best execution obligation on a “downstream” chain of dealers is impractical, unfair, anti-competitive, and unworkable in the case of the bond market. BMA argues that such an obligation should not be imposed on recipient broker-dealers because there is no pre-trade quote transparency, no mandatory firm quote obligation, and no uniform, regulated inter-market and inter-dealer linkage.⁷ BMA fails to recognize that the Best Execution Rule has been in place since 1968. It was adopted at a time when the market structure of the OTC market was quite different. There was significantly less market transparency. Trading decisions and pricing information was based upon telephone and wire quotations as well as quotations in the National Quotation Bureau sheet. At that time, in response to a recommendation made in Chapter VII of the Report of Special Study of Securities Markets of the Securities and Exchange Commission,⁸ NASD had recently adopted a policy with respect to firmness of quotations. Furthermore, no uniform, regulated inter-market, inter-dealer linkage existed.

⁷ BMA notes in its comment letter that the fixed income market is, in fact, not a single market, but in effect, several different markets ranging from the U.S. Treasury market, where dealer quotations may be very representative of market prices and quotations on trading systems may be executable, to the corporate bond market, where large and active issuers may be actively quoted and where screens may provide good transparency for certain securities of active issuers (but not for other securities or issuers), to the market for distressed and emerging market paper and derivative instruments, such as structured notes, where there may be limited trading, quoting or transparency. Notwithstanding these observations, they do not obviate the application of the Best Execution Rule in wholesale fashion. As discussed subsequently in the text, NASD’s Best Execution Rule looks at a number of factors, including the character of the market for the security, to determine whether a member or associated person(s) has used reasonable diligence. Accordingly, it can be applied in a variety of different markets that can possess divergent characteristics, including the U.S. debt market.

⁸ See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 674 (1963).

The fact is that the Best Execution Rule has been in force since the time when the OTC equity market more closely resembled the current fixed income market.

The principles embodied in the Best Execution Rule have evolved over time with changes in technology and the structure of the financial markets.⁹ This evolution arises because the standard in the Best Execution Rule is one of “reasonable diligence” that is assessed by examining specific factors including “the character of the market for the security.” Accordingly, the determination as to whether a member has satisfied its best execution obligations necessarily involves a “facts and circumstances” analysis. In sum, in its refutation of the best execution obligation in the context of the debt markets, BMA is incorrect as a matter of law and regulation. Moreover, BMA’s policy attack on this important investor protection safeguard is fatally undermined by the elasticity of Rule 2320 in its recognition that the character of the market will be among the reasonable diligence factors in the execution of the obligation.

BMA posits that extending best execution obligations to customers of another broker-dealer is inconsistent with a customer’s reasonable expectations of how its orders will be handled because the customer would not have the same expectations of the chain of “unknown” intermediary firms involved in its transactions. NASD strongly disagrees

⁹ The SEC has expressly recognized the evolving nature of the best execution obligations of broker-dealers. See, e.g., Final Rules, 61 Fed. Reg. at 48322-23 (“The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade more advantageous prices. As these changes occur, broker-dealers’ procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become ‘reasonably available.’”). Accordingly, the principles embodied in the text of the Best Execution Rule are applicable to a variety of different market structures and evolve as the market structure for a particular type of security evolves.

with BMA.¹⁰ BMA's assertion that customers' expectations would somehow be different when an "unknown" intermediary is involved is inconsistent with the generally recognized principle that customers generally seek their own economic gain and that broker-dealers have a corresponding duty to use reasonable efforts to maximize the economic benefits for their customers.¹¹ There is nothing in the case law that suggests that a broker-dealer's determination to use an unrelated intermediary should relieve its duties in this regard. NASD strongly believes that customers are entitled to receive equivalent best execution protections without regard to whether their order is executed by the originating broker-dealer or routed to or through another broker-dealer for execution.

The Securities Industry Association (SIA) and Instinet Group Incorporated (Instinet) submitted comment letters that, taken together, promote the view that a recipient broker-dealer's compliance with the terms of conditions of the order, as communicated by the originating broker-dealer, solely, should constitute satisfaction of its best execution obligation with regard to such routed orders. SIA and Instinet assert

¹⁰ It has been NASD's consistent position since at least 1963 that "the integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed." *See*, Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 624 (1963).

¹¹ *See*, e.g., Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998)(en banc) (citation omitted), cert. denied sub nom., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Kravitz, 525 U.S. 811 (1998). The Court, in the context of an agency relationship, recognized that customers seek their own economic gain. Specifically, the Court stated that "... the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction."

that this is appropriate because the recipient broker-dealer is not in the same position as the routing firm to weigh the relative importance of various factors related to each customer, as it usually has no knowledge of the actual customer.

NASD disagrees with the arguments of SIA and Instinet. The recipient member is certainly entitled to rely on the routing member to understand the terms of the order absent any other direct contact with the customer; with that allowance noted, the recipient member is not at any further disadvantage in complying with the terms of Rule 2320, and, consequently, investor protection requires that recipient members must be subject to all of the relevant reasonable diligence factors in determining whether best execution has occurred as a matter of fact and circumstance.

Instinet also asserted that the proposal would create an unfair competitive disparity between otherwise similarly situated market centers that execute orders on an electronic agency basis because the proposed rule would not apply to market centers operated by NASD and other SROs. Instinet requests that NASD revise the proposal to exclude member-operated ECNs and ATSs that interact with orders on a fully automated basis, or else apply the same obligations under the proposal to the market centers operated by NASD and other SROs.¹² As noted above, NASD has responded to this

¹² Instinet also claims that, in light of Regulation NMS' effects on interaction among market centers and the potential conflicts and interpretive issues, NASD's proposal could be interpreted to require a market center (the recipient broker-dealer) to consider routing an order to another market center displaying a better price even though the originating broker-dealer already has indicated that it has attempted to access such interest. NASD's Best Execution Rule contains a number of factors that are examined to determine whether a member or associated person has used reasonable diligence, including "accessibility of the quotation." Accordingly, the facts and circumstances surrounding the "accessibility of the quotations" would be considered to the extent they are appropriate.

comment, as well as BMA's, by deleting proposed references to market centers and simply using the term "market." For purposes of Rule 2320, this term should be interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security.

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)

NASD requests the Commission to find good cause pursuant to Section 19(b)(2) of the Act for approving the proposed rule prior to the 30th day after its publication in the Federal Register. Specifically, NASD requests the Commission approve this Amendment No. 3 at the same time as the overall proposed rule change. NASD believes the proposed amendment is a necessary aspect of the rule change as it revises the text of the rule proposal and provides interpretive guidance in response to comments.

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 the rule change marked to indicate additions to and deletions from the text as proposed in Amendment No. 2 on February 14, 2005.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

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

SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend NASD's Best Execution Rule

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. ("NASD"), filed with the Securities and Exchange Commission ("SEC" or "Commission") Amendment No. 3 to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

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

* * * * *

2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

(1) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

(2) the size and type of transaction;

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

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

(5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

(b) through (g) No change.

* * * * *

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

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

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

1. Purpose

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. NASD has received a number of questions regarding the application of the term “customer” in the context of best execution. Rule 0120(g) defines “customer” to exclude a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer (“originating broker-dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could argue that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker-dealer.

NASD believes that not applying the Best Execution Rule to recipient members is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker-dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice. The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another

broker-dealer.

On February 11, 2004, NASD submitted to the SEC rule filing SR-NASD-2004-026 requiring that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. The proposal also sought to clarify that the recipient member was not required to enter into any such written agreements with the originating broker-dealer, and that the originating broker-dealer (to the extent it is was a member) would remain obligated to comply with the Best Execution Rule, irrespective of whether such an agreement existed.

On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing. Amendment No. 1 continued to require that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. In addition, Amendment No. 1 added a new reasonable diligence factor to the text of the Best Execution Rule that required consideration of the existence of a written agreement or written representations when a customer order is routed to another broker-dealer. Also, the amendment modified the text of new proposed paragraph (a)(2) of the Best Execution Rule. Lastly, the amendment provided proposed interpretive guidance concerning Rule 2320, as amended.

On February 14, 2005, NASD submitted to the SEC Amendment No. 2 to SR-

NASD-2004-026, which required that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer without regard to whether a customer order is executed by the originating broker-dealer or routed to another broker-dealer.³ Amendment No. 2 also proposed changes to modernize the text of the rule. Specifically, NASD proposed an amendment to clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all market centers in which a security is traded. In addition, Amendment No. 2 amended the reasonable diligence factors to reflect current market structure and to delete outdated terms. In particular, NASD proposed amending the reference to the “number of primary markets checked” to instead refer to “the number of market centers checked.” Amendment No. 2 also added a new factor that examines the “terms and conditions of the order” in determining whether a member has used due diligence.

Proposal

Today, NASD is filing Amendment 3, which deletes proposed references to market centers and simply uses the term “market.” NASD is making this change in response to comments that suggest that the term “market center” would: 1) create an unfair competitive disparity in the equity market; and 2) create confusion and problems of interpretation, application, and enforcement in the debt market. While the term “market” has been in the text of Rule 2320 since its adoption, it is an undefined term. Accordingly, NASD is providing interpretive guidance that states that, for purposes of Rule 2320, the term “market” or “markets” should be interpreted broadly to include a

³ NASD staff continues to believe this approach is preferable to that specified in the original rule proposal and Amendment No. 1 because customer orders will receive best execution protections without regard to whether there is a written agreement or written representations from a recipient member.

variety of different venues, including, but not limited to, market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of best execution.

NASD also is providing interpretive guidance concerning how the Best Execution Rule should be applied in the debt market with respect to the “accessibility of the quotations” reasonable diligence factor. When quotations are available, such as for certain liquid debt securities, NASD will consider the “accessibility of such quotations” when examining whether a member has used due diligence. For purposes of debt, the term “quotation” refers to either dollar (or other currency) pricing or yield pricing.⁴

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

⁴ NASD notes, however, that accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule 2320. In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets, and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

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

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

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

On February 25, 2005, the SEC published SR-NASD-2004-026 for public comment in the Federal Register.⁵ The SEC received three comment letters in response to the publication of the rule proposal in the Federal Register.⁶

The Bond Market Association (BMA) submitted a comment letter stating, among other things, its belief that NASD only considered equities trading when drafting the

⁵ Securities Exchange Act Rel. No. 51229 (February 18, 2005), 70 FR 9416 (February 25, 2005) (Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2).

⁶ Letter from The Ad Hoc Best Execution Committee of the Securities Industry Association dated March 18, 2005; letter from Instinet Group Incorporated dated March 22, 2005; and letter from The Bond Market Association dated April 5, 2005.

proposed rule change.⁷ Specifically, BMA states that NASD's proposed change of terminology in an attempt to clarify and modernize the Best Execution Rule exemplifies how the rule change was drafted to address equities trading only and states further that changing "inter-dealer" markets to "market centers" has no meaning in the context of the bond market. BMA believes the proposal is inappropriate for fixed income securities and, if adopted, would exacerbate existing difficulties with regard to bond trading. In addition, BMA believes applying the Best Execution Rule, as amended, is impractical, unfair, anti-competitive, unworkable in the case of the bond market, and inconsistent with a customer's reasonable expectations of how its orders will be handled.

NASD appreciates the comments of BMA but does not find them to be persuasive. Essentially, BMA is advocating, for a number of reasons, that the Best Execution Rule is not applicable to the debt market. However, the terms of Rule 2320 have never been limited to equity securities and the consistency of this observation is expressed in Rule 0116 in which the Best Execution Rule, among others, is made applicable to transactions and business activities relating to exempted securities (other than municipal securities) conducted by members and associated persons.⁸

⁷ NASD did not intend to only consider equity trading when drafting this proposal. In this rule proposal, NASD is again clarifying that the Best Execution Rule is applicable to the debt market, and is providing additional interpretive guidance. Specifically, NASD is providing interpretive guidance with respect to the "accessibility of the quotations" reasonable diligence factor and the application of this factor in the debt market. When quotations are available, such as for certain liquid debt securities, NASD will consider the "accessibility of such quotations" when examining whether a member has used due diligence. In such instances, the term "quotation" refers to either dollar (or other currency) pricing or yield pricing.

⁸ See Securities Exchange Act Rel. No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Approval of SR-NASD-2000-38).

Further, BMA asserts that the term “market center” is an equity term and cannot be applied in the context of debt. We acknowledge that the term “market center” has traditionally been used in connection with certain equity securities. For example, SEC Rule 11Ac1-5(a)(14), which is applicable to national market system securities, defined “market center” as any exchange market maker, over-the-counter (OTC) market maker, alternative trading system, national securities exchange, or national securities association. In seeking to modernize the Best Execution Rule, NASD sought a recognized term that was aimed broadly at capturing order execution venues. However, in response to comments, including BMA’s concerns that use of this term may introduce confusion in the debt market, NASD has determined to amend the Best Execution Rule to instead use the term “market.” It should be noted, as discussed above, that the term “market” or “markets” for purposes of Rule 2320, should be interpreted broadly to include a variety of different venues, including but not limited to market centers that are trading a particular security. Such an expansive interpretation is for the purposes of both informing broker-dealers as to the scope of venues that must be considered in the furtherance of their best execution obligations and promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge; it is not NASD’s intention to mandate that certain trading venues have less relevance than others in the course of best execution.

BMA also believes imposing a best execution obligation on a “downstream” chain of dealers is impractical, unfair, anti-competitive, and unworkable in the case of the bond market. BMA argues that such an obligation should not be imposed on recipient broker-dealers because there is no pre-trade quote transparency, no mandatory firm quote

obligation, and no uniform, regulated inter-market and inter-dealer linkage.⁹ BMA fails to recognize that the Best Execution Rule has been in place since 1968. It was adopted at a time when the market structure of the OTC market was quite different. There was significantly less market transparency. Trading decisions and pricing information was based upon telephone and wire quotations as well as quotations in the National Quotation Bureau sheet. At that time, in response to a recommendation made in Chapter VII of the Report of Special Study of Securities Markets of the Securities and Exchange Commission,¹⁰ NASD had recently adopted a policy with respect to firmness of quotations. Furthermore, no uniform, regulated inter-market, inter-dealer linkage existed. The fact is that the Best Execution Rule has been in force since the time when the OTC equity market more closely resembled the current fixed income market.

⁹ BMA notes in its comment letter that the fixed income market is, in fact, not a single market, but in effect, several different markets ranging from the U.S. Treasury market, where dealer quotations may be very representative of market prices and quotations on trading systems may be executable, to the corporate bond market, where large and active issuers may be actively quoted and where screens may provide good transparency for certain securities of active issuers (but not for other securities or issuers), to the market for distressed and emerging market paper and derivative instruments, such as structured notes, where there may be limited trading, quoting or transparency. Notwithstanding these observations, they do not obviate the application of the Best Execution Rule in wholesale fashion. As discussed subsequently in the text, NASD's Best Execution Rule looks at a number of factors, including the character of the market for the security, to determine whether a member or associated person(s) has used reasonable diligence. Accordingly, it can be applied in a variety of different markets that can possess divergent characteristics, including the U.S. debt market.

¹⁰ See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 674 (1963).

The principles embodied in the Best Execution Rule have evolved over time with changes in technology and the structure of the financial markets.¹¹ This evolution arises because the standard in the Best Execution Rule is one of “reasonable diligence” that is assessed by examining specific factors including “the character of the market for the security.” Accordingly, the determination as to whether a member has satisfied its best execution obligations necessarily involves a “facts and circumstances” analysis. In sum, in its refutation of the best execution obligation in the context of the debt markets, BMA is incorrect as a matter of law and regulation. Moreover, BMA’s policy attack on this important investor protection safeguard is fatally undermined by the elasticity of Rule 2320 in its recognition that the character of the market will be among the reasonable diligence factors in the execution of the obligation.

BMA posits that extending best execution obligations to customers of another broker-dealer is inconsistent with a customer’s reasonable expectations of how its orders will be handled because the customer would not have the same expectations of the chain of “unknown” intermediary firms involved in its transactions. NASD strongly disagrees with BMA.¹² BMA’s assertion that customers’ expectations would somehow be different

¹¹ The SEC has expressly recognized the evolving nature of the best execution obligations of broker-dealers. See, e.g., Final Rules, 61 Fed. Reg. at 48322-23 (“The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade more advantageous prices. As these changes occur, broker-dealers’ procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become ‘reasonably available.’”). Accordingly, the principles embodied in the text of the Best Execution Rule are applicable to a variety of different market structures and evolve as the market structure for a particular type of security evolves.

¹² It has been NASD’s consistent position since at least 1963 that “the integrity of the industry can be maintained only if the fundamental principle that a customer

when an “unknown” intermediary is involved is inconsistent with the generally recognized principle that customers generally seek their own economic gain and that broker-dealers have a corresponding duty to use reasonable efforts to maximize the economic benefits for their customers.¹³ There is nothing in the case law that suggests that a broker-dealer’s determination to use an unrelated intermediary should relieve its duties in this regard. NASD strongly believes that customers are entitled to receive equivalent best execution protections without regard to whether their order is executed by the originating broker-dealer or routed to or through another broker-dealer for execution.

The Securities Industry Association (SIA) and Instinet Group Incorporated (Instinet) submitted comment letters that, taken together, promote the view that a recipient broker-dealer’s compliance with the terms of conditions of the order, as communicated by the originating broker-dealer, solely, should constitute satisfaction of its best execution obligation with regard to such routed orders. SIA and Instinet assert that this is appropriate because the recipient broker-dealer is not in the same position as the routing firm to weigh the relative importance of various factors related to each

should at all times get the best available price which can reasonably be obtained for him is followed.” *See*, Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 624 (1963).

¹³ *See*, e.g., Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998)(en banc) (citation omitted), cert. denied sub nom., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Kravitz, 525 U.S. 811 (1998). The Court, in the context of an agency relationship, recognized that customers seek their own economic gain. Specifically, the Court stated that “. . . the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.”

customer, as it usually has no knowledge of the actual customer.

NASD disagrees with the arguments of SIA and Instinet. The recipient member is certainly entitled to rely on the routing member to understand the terms of the order absent any other direct contact with the customer; with that allowance noted, the recipient member is not at any further disadvantage in complying with the terms of Rule 2320, and, consequently, investor protection requires that recipient members must be subject to all of the relevant reasonable diligence factors in determining whether best execution has occurred as a matter of fact and circumstance.

Instinet also asserted that the proposal would create an unfair competitive disparity between otherwise similarly situated market centers that execute orders on an electronic agency basis because the proposed rule would not apply to market centers operated by NASD and other SROs. Instinet requests that NASD revise the proposal to exclude member-operated ECNs and ATs that interact with orders on a fully automated basis, or else apply the same obligations under the proposal to the market centers operated by NASD and other SROs.¹⁴ As noted above, NASD has responded to this comment, as well as BMA's, by deleting proposed references to market centers and simply using the term "market." For purposes of Rule 2320, this term should be

¹⁴ Instinet also claims that, in light of Regulation NMS' effects on interaction among market centers and the potential conflicts and interpretive issues, NASD's proposal could be interpreted to require a market center (the recipient broker-dealer) to consider routing an order to another market center displaying a better price even though the originating broker-dealer already has indicated that it has attempted to access such interest. NASD's Best Execution Rule contains a number of factors that are examined to determine whether a member or associated person has used reasonable diligence, including "accessibility of the quotation." Accordingly, the facts and circumstances surrounding the "accessibility of the quotations" would be considered to the extent they are appropriate.

interpreted broadly to include a variety of different venues, including, but not limited to, market centers that are trading a particular security.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NASD and, in particular, the requirements of Section 15A of the Act and the rules and regulations thereunder. The Commission finds good cause for approving the proposed rule change as amended by Amendment No. 3 prior to the 30th day after the date of publication of notice of filing thereof in that Amendment No. 3 is simply responsive to commenters' concerns.

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-2004-026 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-2004-026. 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-2004-026 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.¹⁵

Secretary

¹⁵ 17 CFR 200.30-3(a)(12).

EXHIBIT 4

Below is the text of the proposed rule change marked to indicate additions and deletions from the text as proposed on February 14, 2005 in Amendment No. 2. Previously proposed changes that are no longer being sought are crossed out (~~crossed out~~).

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2300. TRANSACTIONS WITH CUSTOMERS

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2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market ~~center~~ for the subject security and buy or sell in such market ~~center~~ so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

- (1) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
- (2) the size and type of transaction;
- (3) the number of [primary] market{s} ~~centers~~ checked;
- (4) accessibility of the quotation [location and accessibility to the customer’s broker/dealer of primary markets and quotations sources.]; and
- (5) the terms and conditions of the order which result in the transaction,
as communicated to the member and persons associated with the member.

(b) through (g) No change.

* * * * *