



August 17, 2004

Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Re: **SR-NASD-2004-026: Proposed Amendments to NASD Rule 2320(a), NASD's Best Execution Rule; Amendment No. 1**

Dear Ms. Sweeney:

The Ad Hoc Best Execution Committee (the "Committee") of the Securities Industry Association (the "SIA")¹ has reviewed the amendments to the National Association of Securities Dealers, Inc. ("NASD") Rule 2320(a) (the "Best Execution Rule") proposed in the above-referenced rule filing (the "Proposed Rule").² Given the important and potentially far-reaching implications of the Proposed Rule, SIA created this Committee several months ago to study the proposal. Members of the Committee met with representatives from the NASD General Counsel's office and Market Regulation Department on June 2, 2004 to discuss the Committee's concerns with the Proposed Rule. We very much appreciate the NASD staff's willingness to consider our views, and are submitting this letter to clarify our position further and to offer to work with the NASD to address its concerns in this area.

NASD states that this Proposed Rule is a result of the comments received on NASD Notice-to-Members 02-40 ("NTM 02-40"),³ in which they suggested certain amendments to the current Best Execution Rule. As discussed in more detail below, in September 2002 the SIA submitted a comment letter generally opposing the amendments

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in U.S. revenue and \$278 billion in global revenues. (More information about the SIA is available on its home page: www.sia.com.)

² Members of the Committee began expressing concerns soon after the rule filing was posted to the NASD website in February 2004. On May 11, 2004, the NASD submitted Amendment No. 1 to the Securities and Exchange Commission ("SEC"). The SEC has not yet published the rule filing for comment.

³ See Notice To Members 02-40 available at www.nasdr.com/pdf-text/0240ntm.pdf.

proposed in NTM 02-40 (the "September 2002 Comment Letter").⁴ We share NASD's concerns about alleged trading abuses by certain market participants and wish to work with NASD to ensure that adequate safeguards are in place to combat such abuses. However, we feel it equally important to avoid regulation that, in the name of addressing these alleged abuses, misplaces the regulatory obligations of market participants. It is the routing broker-dealer that, by virtue of its relationship with the customer, can and should be responsible for determining and satisfying its customers' expectations for best execution. A regulatory framework that requires contractual best execution commitments from a recipient broker-dealer will not put that party in a position to adequately assess and provide best execution to those orders.

A. Overview

NTM 02-40 and the Proposed Rule generally address obligations of a member firm that receives customer orders for execution from another broker-dealer. As stated during our June 2 meeting, we agree with NASD that best execution obligations provide important protections to investors, and we believe it is important that NASD periodically review these and other existing regulatory requirements to ensure that investors continue to be afforded a high level of protection. The Committee, however, continues to believe in the principles stated in the SIA's September 2002 Comment Letter and, therefore, maintains that the current rule proposal is unnecessary in light of the effective nature of safeguards already in place. Part of the effectiveness of these safeguards is that they appropriately recognize the differing roles and relative access to customer information of an originating broker-dealer when contrasted with a recipient broker-dealer. Best execution obligations are complex and involve many factors, such as speed of execution, enhanced liquidity, and the possibility of price improvement; this fact was central to our deliberations and conclusions regarding the Proposed Rule.

We share the NASD's expressed concerns with alleged trading abuses by certain market participants. In this regard, we wish to work with NASD staff to find ways in which it can respond to these alleged abuses within the context of the current regulatory framework. We believe that this will achieve NASD's desired goal of enhanced investor protection, but without imposing onerous, previously unrecognized obligations on recipient broker-dealers to parties with whom they have no relationship and about whom they have limited information, relative to the routing broker-dealer.

B. Background on SR-NASD-2004-026

NASD proposes in the Proposed Rule filing to amend the current Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a written agreement between the originating broker-dealer and

⁴ See Letter to Barbara Z. Sweeney, Office of the Corporate Secretary, NASD, from George Jennison, SIA Trading Committee, and Christopher Franke, SIA Self-Regulation and Supervisory Practices Committee, dated September 9, 2002.

the recipient member or written representations from the recipient member that it will provide best execution to the originating broker-dealer's customer orders. The Proposed Rule change also would clarify that the originating broker-dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists. Accordingly, an originating broker-dealer member must ensure its best execution obligations to its customers are met, and cannot rely on a written agreement or written representation as a safe harbor.

NASD states in the Proposed Rule that it expects that the existence of such a written agreement or representation from a recipient broker-dealer will be a significant factor in determining whether the originating broker-dealer member has met its best execution obligations when routing customer orders. In addition, there is a strong presumption that, as part of its Rule 2320 best execution obligations, an originating broker-dealer member must seek to obtain a written agreement that expressly states that the recipient broker-dealer will provide the originating broker-dealer's customers with best execution when the originating broker-dealer member has discretion to route the customers' order flow to a recipient broker-dealer (*i.e.*, non-directed orders) and does so on a regular basis.

C. SIA continues to support the positions expressed in its September 2002 Comment Letter on NTM 02-40, and accordingly believes that the amendments proposed in SR-NASD-2004-026 are unnecessary

In its September 2002 Comment Letter, the SIA expressed the view that clarification or extension of the scope of the duty of best execution is unnecessary and inappropriate. The Committee supports this position, and the underlying reasons articulated in that letter. Those reasons, along with certain additional ones, also support the present view that the Proposed Rule is unnecessary. These arguments are set forth below.

1. Effective Investor Safeguards and Practices Already in Place

SIA member firms believe that there are effective safeguards already in place and, as such, there is no need for modification of the Best Execution Rule or for written agreements or representations between an originating broker-dealer and an executing broker-dealer. Routing broker-dealers are currently obligated to provide best execution protection to their customers' orders, whether those orders are executed internally or routed to another broker-dealer. The vast majority of firms takes their best execution obligations very seriously and, as an important component of those obligations, regularly and rigorously examines the quality of executions received from both internal market making desks and from recipient broker-dealers who may execute orders on their behalf.

Recipient broker-dealers must provide executions of sufficiently high quality so as to allow the routing broker-dealer to fulfill its best execution obligations to its customers' orders. A recipient broker-dealer's failure to consistently provide such high quality

executions would almost certainly require a routing broker-dealer, in performance of its best execution obligations to its customers, to route its orders to another executing broker-dealer. Recipient broker-dealers that fail to give their best execution obligations sufficient focus also would be subject to NASD disciplinary action under the current regulatory framework. In addition to the regulatory structure currently in place, and as we first observed in our September 2002 Comment Letter, recipient broker-dealers have another significant incentive to provide quality executions — the very existence of their business depends on providing executions of sufficiently high quality to allow routing or originating broker-dealers to use their execution services without violating their best execution obligations. In those cases in which a routing broker-dealer questions the quality of an execution, the routing broker-dealer will generally request a price adjustment. The recipient broker-dealer typically will comply to avoid risking the loss of business from the routing broker-dealer.

2. *NASD Has At Its Current Disposal Effective Regulatory Tools That Accurately Reflect the Relative Positions of Routing and Recipient Broker-Dealers*

We believe that the Proposed Rule is unnecessary to secure jurisdiction over a recipient broker-dealer engaged in alleged trading abuses. The NASD already has several, effective enforcement tools at its disposal. In addition, sufficient recourse already exists for all parties if they believe that they did not receive best execution. Customers have remedies against their broker-dealers, and routing broker-dealers against recipient broker-dealers. For example, there are many existing rules that work together with the current Best Execution Rule in a comprehensive program that provides effective protection for all customer orders. These rules include:

- SEC Rule 11Ac1-1 (the "Quote" and "Firm Quote" Rules);
- SEC Rule 11Ac1-4 (the "Limit Order Display Rule");
- the transaction and order routing disclosure obligations under SEC Rules 11Ac1-5⁵ and 11Ac1-6;
- the anti-fraud provisions of SEC Rule 10b-5;
- NASD Rule 2110 ("Just and Equitable Principles of Trade");
- NASD Rule 2110-2 ("Manning") and proposed NASD Rule 2111 (which would extend *Manning* protections to customer market orders);
- NASD Rule 2120 ("Use of Manipulative, Deceptive or Other Fraudulent Devices"); and
- NASD Rules 4600 et seq ("Nasdaq Market Maker Requirements").

⁵ The reports required pursuant to Rule 11Ac1-5 provide an effective means for routing firms to make informed comparisons of execution quality among potential execution destinations, as well as for recipient firms to compare their own executions against those of competitors.

It is our view that these regulations can and do provide an effective safeguard against trading abuses in a manner that accurately recognizes the relative positions of routing and recipient broker-dealers with regard to customer orders. In contrast, the Proposed Rule would effectively juxtapose the roles of those parties, disadvantaging not only the recipient broker-dealer (in its attempt to glean an otherwise unrelated customer's best execution expectations) but, by extension, that customer as well (in terms of orders executed with imperfect customer information).

We understand, however, that the NASD believes that the current construction of the Best Execution Rule presents litigation challenges. Certain market participants engaged in allegedly abusive practices apparently have maintained that, in executing orders for another broker-dealer, they did not violate the Best Execution Rule, strictly on the basis that the transaction was not "for or with a customer." In our view, however, the most effective way for NASD to instill better behavior into the order execution process is by disciplining recalcitrant firms using the current regulatory tools at NASD's disposal (such as pursuant to a claim of "just and equitable principles"), not by enacting a rule that effectively misplaces obligations that should rightly reside with the routing broker-dealer.

3. The Agreements Contemplated by the Proposed Rule Do Not Put The Recipient Broker-Dealer in a Position to Comply With a Best Execution Obligation to the Routing Broker-Dealer's Customer and Would be an Unjustified Administrative and Cost Burden

The Committee believes that written agreements or representations are not an effective solution to the more fundamental issue of where the best execution obligation should properly reside. Such agreements and representations do not recognize the relative roles of routing and recipient broker-dealers and the general disparity in customer information at their disposal. A recipient broker-dealer, absent the availability of such customer information, would be in a relatively poor position to determine and provide best execution to the customer. As such, ascribing the best execution obligation to a recipient broker-dealer would necessitate the production of detailed information regarding the client that the routing broker-dealer, for various reasons, would likely be unwilling or unable to produce. As mentioned earlier, we believe that the current obligation of an originating broker-dealer to regularly and rigorously review the quality of executions provided by a recipient broker-dealer, in conjunction with the availability of Rule 11Ac1-5 data to support such a review, more accurately recognizes that routing broker-dealers are in a better position to ensure that their customers' orders are executed in a manner consistent with best execution principles. In addition, the Committee believes that the use of written agreements or representations would create significant administrative burdens and costs for broker-dealers, without real or incremental benefits for investors.

4. *Amendments Raise Privity Concerns*

The Committee is concerned that the language of the Proposed Rule could be mistakenly interpreted as creating privity between the recipient broker-dealer and the customer of the originating broker-dealer. We believe that the best execution obligation owed to the customer must reside with the originating broker-dealer, as the party that knows the customer. The recipient broker-dealer frequently does not know the customer and, as such, is at a significant disadvantage when attempting to gauge that customer's expectation of best execution (*e.g.*, does the customer value timely execution over price improvement?). As a result, we believe that imposing a regulatory requirement of best execution on the recipient broker-dealer would be unwarranted as it would unfairly require them to undertake an obligation, the satisfaction of which is almost wholly dependent upon having accurate and complete information on the party to whom the obligation is owed.

5. *Amendments Raise Anti-Competitive Concerns*

The Committee also has serious concerns about the potential anti-competitive effects of the rule. As written, the Proposed Rule requires the originating broker-dealer member to seek a written agreement from a recipient broker-dealer, but makes no reference to other recipient executing market centers. When a broker-dealer routes orders to a market center, such as a primary listing exchange, the broker-dealer does not obtain an agreement requiring best execution from that market center. When a broker-dealer receives an order from another broker dealer, the receiving broker-dealer is functioning in its capacity as a market center. From a regulatory parity perspective, it does not make sense to require a best execution undertaking from one market center and not another. Doing so would create an unlevel playing field for NASD member firms versus other market centers such as specialists and exchanges.

6. *Amendments May Reduce Execution Options*

Finally, the Committee believes that the imposition of these written agreements may have a "chilling effect" on many broker-dealers that currently accept and execute routed orders. Unlike those broker-dealers the primary business of which is to accept routed orders for execution, some broker-dealers currently accept and execute routed orders in only specific securities, in specific market sectors, or from broker-dealers with which they have an on-going relationship. The potential regulatory and civil liability emanating from these agreements or representations, in addition to the resulting administrative burdens, may cause those broker-dealers that execute routed orders other than as a core business to withdraw from this business. The Committee believes that this would reduce the number of execution options available to routing broker-dealers and significantly diminish competition for this order flow to the ultimate detriment of retail customers.

D. If NASD is to go forward with this proposal, we strongly recommend the following amendments and clarifications

As stated above, it is our desire to work with the NASD to resolve alleged market abuses without the imposition of new regulations that, in our view, will lead to an incorrect result. As such, and absent our preferred position of withdrawal of the Proposed Rule, we offer for consideration the following recommendations. We note that these are not exclusive recommendations, and we welcome the opportunity to discuss these or other alternatives with the NASD staff.

1. Proposal to Eliminate the Written Agreement/Representation Provision and Modify the Proposed Rule

Based in part on suggestions previously received from NASD, we suggest that proposed sections (a)(1)(E) and (a)(2) of the Proposed Rule could be deleted and the following modifications to the Proposed Rule could be made (*possible new language in italics*):

(a)(1) In any transaction for or with a customer *or the customer of another broker or dealer*, a member and persons associated with a member shall use reasonable diligence to . . .

(a)(2) *For purposes of subparagraph (a)(1), a broker-dealer that receives an order ("recipient member") from a broker-dealer originating an order ("originating broker-dealer") will be deemed to have satisfied its best execution obligation if it executes the order in accordance with the terms and conditions of such order, as communicated by the originating broker-dealer. Nothing in this subparagraph (a)(2) changes the application of subparagraph (a)(1) to an originating broker-dealer member with respect to such order or requires a recipient member to accept an order from any customer or broker-dealer.*

The Committee believes it is inappropriate, both from a legal and policy perspective, to expand a broker-dealer's obligations to parties with whom the broker-dealer has no contractual relationship. Best execution obligations appropriately reside with the broker-dealer that knows the customer (*i.e.*, the originating broker-dealer). The recipient broker-dealer usually does not know the customer and, even with the existence of a written agreement or representation, the recipient broker-dealer would remain relatively unfamiliar with the customer's expectation of best execution.⁶ The Rule

⁶ At least one firm notes that the alternative proposal recognizes the basic legal principles that have long governed the making of oral contracts for the purchase or sale of securities and looks to the agreement created by the acceptance of each of the respective orders and subsequent performance of the parties. The terms and conditions, which form the obligations of the parties to the separate but related contracts, are required to be separately recorded under SEC Rule 17a-3(a)(6) and (7). This simple and well-established legal structure works in all but some of the most heavily fact dependent and isolated circumstances. Rules of general application are never able to address isolated and fact dependent situations and to do so is a

Proposal, if adopted in its current form, would expand a broker-dealer's duty of best execution to parties with whom the broker-dealer has no contractual relationship and no way of knowing what that party's execution priorities might be. Consequently, misunderstandings and disputes will ultimately arise when a recipient broker-dealer makes any reasonable assumption as to what unrelated "customers" would consider to be best execution. We believe that the practical consequence of this may be that the price at which an order was executed may effectively become the sole determinant of best execution. In our view, and we would speculate in the NASD's view as well, this would be entirely the wrong result.⁷

It is therefore important that the NASD clarify that the Proposed Rule does not create privity between the customer of the routing broker-dealer and the recipient broker-dealer, and therein impose a general best execution obligation on the recipient broker-dealer. If the NASD determines that the amendments are necessary, we respectfully urge that its application be limited to allow a recipient broker-dealer to rely on the terms of the order received from the routing broker-dealer (in lieu of a more extensive knowledge of the actual customer) to fulfill its duty of best execution. Additionally, the SIA recommends that the NASD clarify that nothing in this rule proposal requires any broker-dealer to accept any order from any customer or broker-dealer (*i.e.*, broker-dealers should retain the discretion to reject any order).

We note that several recent rule filings address order handling and how firms must treat "customers of their customers."⁸ We believe that it is imperative that the industry address this issue comprehensively. Customers should not have recourse against recipient broker-dealers with which they have no privity of contract. We strongly believe that duties to such customers should be narrowly construed as discussed above.

2. Recipient Broker-Dealer and Originating Broker-Dealer Should Be Free to Negotiate Specific Order Handling Terms

The NASD should clarify in the Proposed Rule change that there is nothing that precludes a recipient broker-dealer from negotiating with a routing broker-dealer any specific order handling terms (*e.g.*, auto execution up to a certain quantity) or other conditions. Moreover, such obligations could be derived from, and measured against, the

disservice to the markets and investors alike. Therefore, the proposed alternative in this letter is a better solution, in that the existing contract making process does not create or even suggest an extended privity like NASD's Proposed Rule.

⁷ As both current Rule 2320 and the Proposed Rule make clear, price is but one among many factors to consider when determining whether a member has provided an order with best execution.

⁸ See, *e.g.*, SR-NASD-2004-089 (Proposed Amendments to Require Price Improvement to Limit Orders in Certain Circumstances) and SR-NASD-2004-045 (Proposed Rule Change to Prohibit a Member from Trading Ahead of a Customer Market Order and to Require the Crossing of Customer Market Orders under Certain Circumstances).

express terms of the order (*e.g.*, if the recipient broker-dealer agrees to best execution obligations such as speed, price, etc., then that would be defined by the terms of the order, which could be expressed on an order ticket, in a written agreement, or in another formal or informal arrangement if the parties so choose).

3. *NASD Should Limit Application of the Rule Proposal to Established, Transparent Markets*

If NASD and SEC determine to proceed with the Proposed Rule, it is essential that its application be limited to established, transparent markets (*e.g.*, Nasdaq stocks) and that it not be applied in those markets where there is no real-time trade reporting nor a disseminated NBBO. With regard to the bond markets, we would advocate a similar analysis but defer to The Bond Market Association to express detailed concerns or recommendations in this area.

E. Conclusion

For the reasons stated herein, we reiterate our view that the best solution is for the NASD to simply withdraw the Proposed Rule entirely and to address any possible trading abuses by certain broker-dealers with existing enforcement tools at its disposal.

Thank you for taking the time to consider our views on this important rule proposal. We would appreciate the opportunity to continue this dialogue with the NASD staff. If you have any questions, you may contact the undersigned at 212-608-1500 or 202-216-2000.

Very truly yours,

Amal Aly
Vice President and
Associate General Counsel

Ann Vlcek
Vice President and
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cc: Mary L. Schapiro, Vice Chairman
Marc Menchel, Executive Vice President and General Counsel
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