



Securities Industry Association

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September 9, 2002

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

Re: NASD Notice to Members 02-40; Proposed Amendments to NASD Rule 2320
(Best Execution Rule)

Dear Ms. Sweeney:

The Trading Committee and the Self-Regulation and Supervisory Practices Committee (collectively, the “Committees”) of the Securities Industry Association (“SIA”)¹ appreciate the opportunity to comment on the National Association of Securities Dealers, Inc.’s (“NASD’s”) proposed amendments to NASD Rule 2320 (“Best Execution Rule” or “Rule”), as set out in Notice to Members 02-40 (“NTM”). The NASD seeks comment on whether the scope of the duty of best execution, as defined in the Rule (“Best Execution”), should be clarified to include customer orders received by a NASD member firm (“recipient broker-dealer”) from another broker-dealer (“routing broker-dealer”)² for execution and, if so, whether the scope of the duty should be limited, defined more broadly, or otherwise amended. In this regard, the NASD proposes several alternative rule amendments to consider.

In addition, the NASD seeks comment on whether the Rule should distinguish between customer orders received by a broker-dealer from a foreign affiliate or foreign broker-dealer as opposed to those received from a domestic affiliate or domestic broker-dealer that is subject to SEC, NASD or other legal obligations concerning Best Execution.

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>.)

² The terms, “recipient broker-dealer” and “routing broker-dealer,” are consistent with those used in NTM 02-40.

Overview

The Committees agree with the NASD that Best Execution obligations provide important protections to investors, and commend the NASD on its efforts to periodically review these and other existing regulatory requirements to ensure that investors continue to be afforded the highest level of protections. The Committees suggest at the outset, however, that it might be more productive to engage in this debate on extending the scope of the duty of Best Execution after the U.S. securities markets have fully absorbed the significant structural changes taking place today. As you know, the industry is experiencing, among other things, the implementation of SuperMontage and the NASD ADF, the trading of Nasdaq securities by additional exchanges on an Unlisted Trading Privileges basis, and the transformation of Nasdaq into an exchange.

The Committees considered the NASD's proposed amendments over the past several weeks, and are pleased to offer their views. The consensus of the Committees is that clarification or extension of the scope of the duty of Best Execution is unnecessary and inappropriate, and could lead to unintended consequences that may cause more harm than good.³ The Committees offer the following reasons for their consensus position, the first two being of greater significance and the last two addressing more technical or administrative issues and questions.

First, the Committees believe that there are effective practices and safeguards already in place. 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. 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, or else the routing broker-dealer is required not to route its orders to that recipient. In addition, there are many existing rules, such as the Firm Quote Rule, the Limit Order Display Rule, Manning, and Rules 11Ac1-5 and 11Ac1-6, that work together with Best Execution in a comprehensive program that provides effective protection for all customer orders.

Second, sufficient recourses already exist 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. In addition, regulators have adequate enforcement tools they can use whenever necessary.

Third, some firms question whether the NASD's proposals raise concerns regarding the privacy of customer information and of recipient broker-dealers' proprietary trading programs and strategies.

³ At least one firm, however, expresses qualified support for the NASD's first proposed amendment (to extend the duty of Best Execution to customer orders where there is an agreement or arrangement between the two broker-dealers that the recipient broker-dealer would comply with the duty of Best Execution); they stated that revision of the Rule in such a manner might be acceptable if the NASD believed it necessary, although they did not advocate such a change.

Fourth, some firms are concerned with the potential administrative costs of monitoring and implementing the NASD's proposals, and question whether such costs would justify the benefits derived therefrom.

With regard to customer orders received by broker-dealers from foreign affiliates or foreign broker-dealers, the Committees recommend that no distinction be drawn under the Rule between such orders and those customer orders received from domestic affiliates or domestic broker-dealers that are subject to SEC, NASD or other legal obligations concerning Best Execution. The Committees believe that making a distinction between these participants in the U.S. markets, in terms of investor protection, is unnecessary and a poor policy in terms of globalization and competition among foreign and domestic marketplaces.

Discussion

A. Clarifying or extending the scope of the duty of Best Execution is unnecessary and inappropriate.

The Best Execution Rule requires a broker-dealer, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. NASD Rule 0120(g) defines customer as not including a broker or dealer, an exclusion that contributed to the NASD's review of the scope of the duty of Best Execution. The NASD explains in the NTM that it is not seeking to revise the definitions either of the duty of Best Execution or of customer; instead, it is considering whether and to what extent it should extend the scope of the duty of Best Execution to include customer orders received by a recipient broker-dealer for execution from a routing broker-dealer. In this regard, the NASD suggested several alternatives for clarifying the scope of this duty under such circumstances, including that it:

- (1) be limited to customer orders where there is an agreement or arrangement between the two broker-dealers that the recipient broker-dealer would comply with the duty of best execution;
- (2) be limited to customer orders routed pursuant to an arrangement or an agreement noted in Notice to Members 97-57 (i.e., where a broker-dealer agrees to provide automated executions to a routing broker-dealer's customers' orders or there is another arrangement between the two broker-dealers – such as a payment for order flow, reciprocal, or correspondent arrangement);
- (3) be limited to customer orders routed pursuant to an arrangement or an agreement (including, but not limited to, those noted in Notice to Members 97-57) where the recipient broker-dealer assesses a fee or charge to execute the order;
- (4) be defined more broadly to include all orders that are identified by the routing member as customer orders; and/or

(5) [be] clarified or amended in some other fashion.

The Committees offer the following reasons for their position that no change should be made in the scope of the duty of Best Execution.

1. Many effective practices and safeguards are already in place.

The routing broker-dealer has a Best Execution obligation for its customer orders, and the recipient broker-dealer uses reasonable diligence to provide executions of sufficiently high quality such that the routing broker-dealer can fulfill its Best Execution obligations to those orders. This is true whether an order is a proprietary order or a customer order and whether there is a routing agreement or not.

Routing firms are required to take steps to ensure that their customers receive executions consistent with the requirements of the Best Execution Rule. We recognize that the duty of Best Execution is not a guarantee of Best Execution, but an obligation to use reasonable diligence to obtain the most favorable price possible under existing market conditions. Routing firms, therefore, must take steps to ensure that their customer orders receive the best price reasonably available in the inter-dealer market. Firms must regularly and rigorously examine the quality of executions received from both their internal market-making desks as well as from the recipient broker-dealers who execute orders on their behalf. In this regard, they often have licensed and trained proprietary and agency traders monitoring all executions on a real-time basis. In addition, some firms contract with an outside vendor to provide them with a daily list of executions compared to the NBBO, and then proceed to review those exceptions with the intention of making price adjustments on behalf of customers' orders where appropriate. Routing firms, therefore, are aware of their Best Execution obligations and take them very seriously.⁴

For recipient firms, execution service is a product they offer to a routing firm. While routing broker-dealers are required by regulation to ensure that their customers' orders receive high quality executions, recipient broker-dealers have an even greater incentive: the very existence of their business depends on providing executions of sufficiently high quality to allow the routing broker-dealer to utilize the recipient broker-dealer without violating the routing broker-dealer's Best Execution obligations. Offering high quality executions to the routing broker-dealer is a competitive tool and, at a minimum and to stay competitive, the executing broker-dealer regularly reviews its practices to ensure that it is providing such high quality executions.

The efforts of both routing and recipient broker-dealers are complemented by the SEC's and the NASD's efforts in recent years to afford greater protections to investors. These efforts include the Firm Quote and Limit Order Display Rules on the part of the SEC, and the Manning Interpretation on the part of the NASD. For example, the Limit Order Display Rule and Manning require recipient broker-dealers to provide the

⁴ Some firms explained that they often do not differentiate between internal customer orders and external customer orders on their proprietary trading desks; in general, they strive to provide high quality executions to all customers, in all cases.

same protections to broker-to-broker orders as they provide to customer orders. In addition, the SEC's recently implemented order disclosure rules, Rules 11Ac1-5 and 11Ac1-6, are designed to provide even greater protections to investors. Rule 11Ac1-5 is an effort to provide the tools necessary for routing firms to make informed comparisons of execution quality among potential execution destinations, for recipient firms to compare their own competitive performance, and for regulators to monitor whether routing firms are performing effective regular and rigorous reviews of execution quality. Rule 11Ac1-6 is an effort to provide the investing public with the tools to make informed decisions about the execution quality profiles of the routing broker-dealers. These rule-making efforts, along with the Best Execution Rule, form the core of a regulatory scheme that already provides significant and effective protection for every order placed by the investing public.

Finally, the Committees are concerned that an expansion of the scope of the duty of Best Execution and a concomitant expansion of its regular and rigorous review obligations could produce unintended and unworkable results. For example, firms are unclear as to how non-internalizing execution destinations can perform the analysis of customer needs required by the regular and rigorous review obligations (and whether such destinations would ever be able to do so under existing privacy laws).

2. Customers and broker-dealers already have sufficient recourses in cases of unsatisfactory execution.

Customers have sufficient recourse against their broker-dealer in the event of an unsatisfactory execution. Firms generally receive few such complaints but, when they do, they review the facts and then make adjustments on behalf of their customers whenever restitution is warranted.

Routing firms have various tools at their disposal to ensure the quality of executions received from recipient broker-dealers. Generally, if the recipient broker-dealer executes an order poorly, then the routing broker-dealer will offer a price adjustment to the order. In turn, the routing broker-dealer has the ability to seek a price adjustment (reimbursement for its own price adjustment to its customer) from the recipient broker-dealer, which they usually do directly or, more rarely, through arbitration. More importantly to the recipient broker-dealer, though, is the enormous leverage that the routing broker-dealer has in the form of the ever-present threat of re-routing.

Regulators already have effective enforcement tools if a recipient firm induces a routing firm to use its execution services and fails to provide the services as represented; the SEC can initiate a Rule 10b-5 action and the NASD can initiate a proceeding under Rule 2110 (just and equitable principles) and/or Rule 2120. The Committees believe that the NASD's proposed amendments would not help the regulators or compliance departments surveil for, or enforce, Best Execution as the proposals do not offer any new information upon which to measure execution quality.

Finally, some firms believe that the alternatives proposed by the NASD may inadvertently expand the definition of customer, which could have an effect on other rules where such effect was unintended.

3. The proposals may raise certain privacy concerns with customer information and firms' proprietary trading programs and strategies.

The Committees note that the NASD's proposed amendments could lead to the requirement for the dissemination of additional customer information from the customer's broker-dealer to the recipient broker-dealer. Some firms question whether this could lead to a conflict with existing privacy rules (and are also concerned with the costs of having to revise automatic trading systems to convey this information, as discussed below). In addition, some firms question whether the proposals could inadvertently require recipient broker-dealers to divulge proprietary algorithms and other trading programs and strategies.

4. The administrative costs of monitoring and implementing these proposals may be significant, and may not justify the benefits derived therefrom.

The Committees are in favor of any proposal that would provide real economic benefits and investor protections to their customers; however, they are uncertain whether the NASD's suggested alternatives would provide either of these. Instead, the Committees question whether these proposals represent an additional burden to firms and increased transaction costs to customers.

Specifically, the Committees are concerned that, without massive reprogramming and street-wide testing (costing millions of dollars), ACT, most vendors (such as BRASS), and/or most proprietary systems could not accept the information about the nature of the order (customer, proprietary, etc.) that the proposals would require. In addition, if a classification mistake were made, it is unclear whether the routing broker-dealer and/or the recipient broker-dealer would be liable.

In summary, the administrative costs of monitoring and implementing these proposals would need to be determined, along with whether the costs would be justified by the benefits to be derived therefrom.⁵

⁵ Some firms had other questions as well when reviewing the rule proposals, in addition to those noted in this section and in the above section no. 3. In particular, these firms questioned the treatment under the proposals of customer orders that are subject to auto-execution systems.

B. The Best Execution Rule should not distinguish between customer orders received by a broker-dealer from foreign affiliates and broker-dealers as opposed to those received from domestic affiliates and broker-dealers.

The Committees believe that no distinction should be drawn under the Rule between customer orders received by a broker-dealer from foreign affiliates or foreign broker-dealers as opposed to those orders received from domestic affiliates or domestic broker-dealers that are subject to SEC, NASD or other legal obligations concerning Best Execution. The Committees believe that we should not create “dual playing fields” on which customer orders from domestic entities receive greater protections than customer orders from foreign entities. Firms believe that this distinction is not only unnecessary, but it would make U.S. firms non-competitive in the global marketplace and is poor policy in terms of furthering globalization.

Conclusion

The Committees appreciate this opportunity to address the important issue of clarifying or extending the scope of the duty of Best Execution, and would be pleased to discuss their views further with the NASD staff. If you have any questions about any of the positions taken in this letter, you may contact Ann Vlcek, Associate General Counsel, at (202) 326-5319.

Very truly yours,

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Trading Committee

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Self-Regulation and Supervisory Practices
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cc: Mary L. Schapiro, Vice Chairman
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