

until no later than 90 days after the approval of this rule filing.<sup>12</sup>

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 6 of the Act<sup>13</sup> in general and with Section 6(b)(5) of the Act,<sup>14</sup> in particular. Section 6(b)(5) requires that Nasdaq's rules be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. The proposed rule change will benefit investors, issuers' counsel, and member firms by providing additional clarity and transparency to Nasdaq's corporate governance standards and promoting greater uniformity with existing corporate governance standards of the NYSE. The additional clarity, transparency, and greater uniformity will also reduce administrative costs associated with compliance with Nasdaq's corporate governance standards.

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

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

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

Written comments were neither solicited nor received.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which Nasdaq consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

<sup>12</sup> The transition period does not affect an issuer's obligation to comply with the requirements related to audit committee composition.

<sup>13</sup> 15 U.S.C. 78f.

<sup>14</sup> 15 U.S.C. 78f(b)(5).

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2006-021 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2006-021. 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. Copies of such filing also will be available for inspection and copying at the principal office of the Nasdaq. 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 File Number SR-NASDAQ-2006-021 and should be submitted on or before September 18, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

Nancy M. Morris,  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54339; File No. SR-NASD-2004-026]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change as Modified by Amendment Nos. 1-5 To Amend NASD Rule 2320(a) Governing Best Execution

August 21, 2006.

#### I. Introduction

On February 12, 2004, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend NASD Rule 2320(a) ("Best Execution Rule"). On May 11, 2004, NASD amended the proposed rule change.<sup>3</sup> On February 14, 2005, NASD amended the proposed rule change a second time.<sup>4</sup> The proposed rule change, as modified by Amendment Nos. 1 and 2, was published for comment in the **Federal Register** on February 25, 2005.<sup>5</sup> The Commission received three comment letters on the proposal.<sup>6</sup> On June 22, 2005, NASD filed a response to comments, and simultaneously amended the proposal.<sup>7</sup> The Commission received one comment

<sup>15</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Amendment No. 1.

<sup>4</sup> See Amendment No. 2.

<sup>5</sup> See Securities Exchange Act Release No. 51229 (February 18, 2005), 70 FR 9416. The proposed rule change was published a second time on October 26, 2005. See footnote 10 *infra*.

<sup>6</sup> See letters from Amal Aly, Vice President ("VP") and Associate General Counsel ("AGC"), and Ann Vlcek, VP and AGC, Securities Industry Association ("SIA") dated March 18, 2005 ("SIA Letter"); Paul A. Merolla, Executive Vice President and General Counsel, Instinet Group, Inc. ("Instinet") dated March 22, 2005 ("Instinet Letter"); Micah S. Green, President and Michele C. David, VP and AGC, The Bond Market Association ("BMA") dated April 5, 2005 ("BMA Letter"), to Jonathan G. Katz, Secretary, Commission. The Commission received one additional comment letter after NASD filed its response to comments, and another letter after the proposed rule change was republished on October 26, 2005. See footnotes 8, 10 and 11, *infra*.

<sup>7</sup> See Amendment No. 3.

letter regarding NASD's response.<sup>8</sup> On September 22, 2005, NASD filed an amendment to modify the purpose section of the proposal, clarifying the scope of a member's duty to provide best execution.<sup>9</sup> The proposed rule change, as modified by Amendment Nos. 3 and 4, was published for comment in the **Federal Register** on October 26, 2005.<sup>10</sup> The Commission received one additional comment letter on the proposed rule change after it was published for the second time.<sup>11</sup> On May 17, 2006, NASD filed Amendment No. 5.<sup>12</sup> This order approves the proposed rule change, as modified by Amendment Nos. 1–5.<sup>13</sup>

## II. Summary of Comments

The Commission received a total of five comment letters from three commenters on the proposed rule change.<sup>14</sup> The SIA notes that NASD made several positive changes to the proposed rule in Amendment No. 2.<sup>15</sup> However, the SIA, the BMA and Instinet all take issue with NASD requiring a member to provide best execution to the customer of another broker-dealer. The commenters assert that the recipient broker-dealer does not have a relationship with the customer and thus should not be subject to the rule, or if subject to the rule, the SIA suggests that, if the recipient broker-dealer complies with the terms and conditions of the order, as communicated by the originating broker-dealer, the recipient broker-dealer should have fulfilled its best execution obligation under the rule.<sup>16</sup>

The BMA, while objecting to this requirement, also believes that the Best Execution Rule should not apply to the

bond market.<sup>17</sup> According to the BMA, the rule would cause problems in the bond market because of the way the market operates.<sup>18</sup> In addition, the BMA believes that the wording of the rule demonstrates that it was not intended to apply to the bond market.<sup>19</sup> After the Commission's receipt of Amendment No. 3, the BMA submitted a second comment letter that reiterates its concerns with the proposal, and states its belief that Amendment No. 3 does not adequately address the BMA's concerns.<sup>20</sup>

Instinet raises two additional points. First, Instinet argues that use of the term "market center" creates a competitive disadvantage because the rule would not apply to market centers operated by NASD and other self-regulatory organizations ("SROs").<sup>21</sup> Instinet asks that NASD either exclude member-operated electronic communications networks ("ECNs") or alternative trading systems ("ATs") that interact with orders on a fully automated basis from the rule, or apply the same obligations to the Nasdaq Market Center and the BRUT facility. Second, Instinet asks that implementation of the proposed rule change be delayed pending Commission action on Regulation NMS, including interpretive guidance with respect to the obligations of market centers under the trade through proposal.<sup>22</sup>

## III. NASD Response to Comments

In response to the comments, NASD filed Amendment Nos. 3 and 4 to the proposed rule change.<sup>23</sup> In Amendment No. 3, NASD states that the failure to apply the Best Execution Rule to recipient broker-dealers is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule itself. As amended, the rule requires a member to use reasonable diligence to ascertain the best market for the particular security and to buy or sell in that market so that the price to the customer is as favorable as possible under the prevailing market conditions. The rule contains five factors that NASD will consider in determining if the broker-dealer used reasonable diligence to ascertain the

best market for the security. Whether the broker-dealer used reasonable diligence is factored into the determination of whether the broker-dealer has met its best execution obligation.

NASD amended the proposed rule change to replace the term "market center" with the term "market," which is a broader term. According to NASD, this change was made to address the BMA's concern that the term "market center" is not relevant in the bond market, as well as Instinet's concern with respect to the proposed rule creating a competitive disadvantage. As amended, the Best Execution Rule will apply to all trading venues.

In response to the BMA's assertion that the proposed rule should not apply to the bond market, NASD stated the rule has "never been limited to equity securities." NASD cites to Rule 0116, which enumerates the NASD rules that apply to government and other exempt securities.<sup>24</sup> The BMA argues that the bond market is not subject to the same requirements as the equities markets, e.g. a firm quote requirement, pre-trade quote transparency, a uniform, regulated inter-dealer market and an inter-dealer linkage.<sup>25</sup> NASD acknowledges the differences in market structure and regulations between the equities markets and the bond markets and notes that, at the time NASD adopted the Best Execution Rule, the equities markets operated in a framework similar to the current framework for bond trading. Furthermore, NASD stated that the term "quotation" refers to either dollar (or other currency) pricing or yield pricing, for purposes of debt, and that accessibility of quotations is a factor in determining if the member used reasonable diligence. If quotations are readily available for a particular debt security, NASD will factor this into its assessment of whether the member complied with its obligations under the rule. In response to BMA Letter 2, NASD clarified the scope of the proposed rule change by stating that a member's duty to provide best execution to customer orders received from other broker-dealers arises when an order is routed to the member for the

<sup>8</sup> See letter from Marjorie Gross, Senior Vice President and Regulatory Counsel, BMA, to Jonathan G. Katz, Secretary, Commission, dated September 7, 2005 ("BMA Letter 2").

<sup>9</sup> See Amendment No. 4.

<sup>10</sup> See Securities Exchange Act Release No. 52637 (October 19, 2005), 70 FR 61861.

<sup>11</sup> See letter from Michele C. David, VP and AGC, BMA, to Jonathan G. Katz, Secretary, Commission, dated November 16, 2005 ("BMA Letter 3").

<sup>12</sup> Amendment No. 5 is a technical amendment. With Amendment No. 5, NASD took the substance of Amendment Nos. 3 and 4 and placed that information in IM-2320.

<sup>13</sup> In August 2005, the Commission approved two related proposed rule changes: SR-NASD-2004-045, which prohibits members from trading ahead of customer market orders in certain circumstances, and SR-NASD-2004-089, which provides additional limit order protection by requiring members to provide price improvement under certain circumstances. See Securities Exchange Act Release Nos. 52226 (August 9, 2005), 70 FR 48219 (August 16, 2005), and 52210 (August 4, 2005), 70 FR 46897 (August 11, 2005).

<sup>14</sup> See footnotes 6, 8 and 11, *supra*.

<sup>15</sup> See SIA Letter at 2.

<sup>16</sup> *Id.*

<sup>17</sup> See BMA Letter at 2, 5.

<sup>18</sup> *Id.* at 1.

<sup>19</sup> *Id.* at 2.

<sup>20</sup> See BMA Letter 2. The Commission notes that the BMA reasserts the concerns it raises in BMA Letters 1 and 2 in BMA Letter 3, and further states that the proposed rule change is deficient because it does not specifically address how certain provisions of the proposal pertain to the bond market. BMA Letter 3 at 1–2.

<sup>21</sup> See Instinet Letter at 2 and 3.

<sup>22</sup> *Id.* at 3.

<sup>23</sup> See footnotes 7 and 9, *supra*.

<sup>24</sup> See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001)(SR-NASD-2000-38)(order approving NASD Rule 0116)("Exempted Securities Order"). See also, Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996)(order approving NASD's proposal implementing the expanded sales practice authority granted to NASD pursuant to the Government Securities Act Amendments of 1993 and listing the NASD rules that would apply to exempted securities. Among the rules was the Best Execution Rule.

<sup>25</sup> See BMA Letter at 4.

purpose of order handling and execution.<sup>26</sup>

Amendment No. 5 is purely a technical amendment, as its substance was published for notice and comment in Amendment Nos. 3 and 4. With Amendment No. 5, NASD took the substance of Amendment Nos. 3 and 4 and placed that information in IM-2320.

#### IV. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change, the comment letters, and NASD's response to the comments, and believes that NASD has responded appropriately to the concerns raised by the commenters. The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities association, and, in particular, with Section 15A(b)(6) of the Act, which requires, among other things, that the rules of a national securities association 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.<sup>27</sup> Regarding the commenters' assertion that a recipient broker-dealer's compliance with the terms and conditions of the order, as communicated by the originating broker-dealer, solely, should constitute satisfaction of the duty of best execution with regard to routed orders, the Commission believes that such compliance should be considered a significant factor in determining if the recipient broker-dealer has met its duty of best execution, but should not be the sole factor to consider. In Amendment Nos. 3 and 4, NASD addressed the concerns raised by commenters. In response to issues raised by the BMA, NASD changed the terminology of the proposed rule change, replacing "market center" with "market" and stating that it will interpret the term broadly. Additionally, the Commission notes that the Best Execution Rule currently applies to the bond markets.<sup>28</sup> NASD indicated in its amendment how it intends to apply the factors in the rule that provide evidence of reasonable diligence in the context of the bond market, and how it will interpret price

in connection with debt. In Amendment No. 4, NASD made a clear distinction between a member's duties when acting as provider of liquidity versus acting as an order handler for another broker-dealer. The Commission believes that the revisions clarify how the rule applies in the context of the debt market. Furthermore, the Commission notes that, at the time NASD adopted its Best Execution Rule, the equity markets were subject to a regulatory regime similar to the one under which the bond markets operate today.<sup>29</sup> The Commission expects that the NASD will take into account the structure and operation of the debt markets when applying the rule to debt market participants.

With regard to the commenters' claim that the proposal would create an unfair competitive disparity between otherwise similarly situated market centers that execute orders on an electronic agency basis, the Commission notes that electronic communications networks ("ECNs") are subject to a different regulatory regime than SROs. ECNs are broker-dealers by definition, and must be members of an SRO; consequently ECNs are subject to SRO rules. Moreover, the Commission believes the proposed rule change, as amended, will not unfairly affect ECN operations.

With respect to the commenters' concern that implementation of this proposal should be delayed until after the Commission has adopted guidance under the trade through proposal of Regulation NMS, the Commission notes that the Commission adopted Regulation NMS subsequent to the commenters filing their comment letters.

Finally, the Commission views markup obligations and the duty of best execution as separate and distinct requirements. NASD Rule 2320(f) states that best execution obligations "do not relate to the reasonableness of commission rates, markups or markdowns which are governed by Rule 2440 and IM-2440."

#### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>30</sup> that the

<sup>29</sup> As NASD notes, in 1968 when the Best Execution Rule was adopted, the market for equity securities was much different than it is today. For example, there was no consolidated tape and thus no readily available trade or quotation information. Market makers in over-the-counter securities conducted transactions via telephone, after checking prices either in the pink sheets or by information they obtained using the telephone. In addition, there was no requirement to report transactions to NASD within 90 seconds.

<sup>30</sup> 30 15 U.S.C. 78s(b)(2).

proposed rule change (SR-NASD-2004-026), as modified by Amendment Nos. 1-5, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>31</sup>

Nancy M. Morris,  
Secretary.

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54334; File No. SR-NASD-2006-097]

#### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Extend a Pilot Program That Increases Position and Exercise Limits for Certain Equity Options

August 18, 2006

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 10, 2006, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by NASD. NASD has filed the proposal as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders it effective upon filing with the Commission. 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 proposes to amend NASD Rule 2860 to extend a pilot program increasing certain options position and exercise limits. The text of the proposed rule change is available on NASD's Web site (<http://www.nasd.com>), at NASD's principal office, and at the Commission's Public Reference Room.

<sup>31</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>26</sup> See footnote 9, *supra*.

<sup>27</sup> 15 U.S.C. 78o-3(b)(6). In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>28</sup> See footnote 24, *supra*, and Exempted Securities Order.