

## Net Trading, Market Making, and the SEC's View of Best Execution

A recent Securities and Exchange Commission (SEC or Commission) settlement involving Morgan Stanley & Co. (MS & Co. or the Firm)<sup>1</sup> raises important issues regarding coordination among various departments in firms and also provides an interesting window into the SEC's view of best execution in the context of net, riskless principal trading.

Accordingly, we discuss below:

- (I) The basic facts of the settlement.
- (II) The importance of clear communication and coordination among legal, compliance, business, and technology departments when designing, implementing, and maintaining operating systems and compliance policies and procedures.
- (III) The applicability of the best execution rule to net, riskless principal trading.
- (IV) Potential lessons to be drawn from the settlement.

### I. The Settlement

The SEC recently settled a case with MS & Co. involving the Firm's alleged failure to provide best execution to certain customer orders in Nasdaq stocks in which the Firm was a market maker. According to the Settlement Order, the settlement involved orders executed by MS & Co.'s market-making desk received from the Firm's own retail unit, its retail broker-dealer affiliate on behalf of the affiliate's customers, and other third-party broker-dealers on behalf of those firms' retail customers. MS & Co. filled the orders on a principal basis, but it did not take market risk. In other words, with the order in hand, MS & Co. would trade with another market center (i.e., the Street) for its own account, and then fill the open order. The Settlement Order refers to all of these orders as customer orders, without distinguishing among them by source.<sup>2</sup>

At its core, the Settlement Order finds that:

- (1) MS & Co. would at times execute with the Street at a better price than the price at which it executed the order it was holding, capturing the difference for itself;
- (2) This practice was inconsistent with MS & Co.'s policies and procedures, which required the market-making desk to execute the order at the same price that MS & Co. received from the Street;
- (3) This practice was inconsistent with MS & Co.'s disclosure to certain third-party retail broker-dealers that routed orders to it electronically that the Firm would seek to provide best execution to routed orders and would not charge any mark-up, mark-down, commissions, or other fees on the routed orders; and
- (4) MS & Co. violated its duty of best execution and, consequently, Section 15(c)(1)(A) of the Securities Exchange Act of 1934 (Exchange Act).

The Settlement Order describes in some detail how the Firm programmed its market-making systems to capture the difference between the price the Firm received from the Street and the price at which it filled the orders, how this programming changed over time, and how this programming impacted different types of orders. Although not entirely clear, it appears that the programming was consistent over time in one respect: it only permitted the Firm to retain the difference between the price it received from the Street and the price at which it filled the customer order if the customer received an execution at the National Best Bid (for customer sales) or National Best Offer (for customer purchases). The Settlement Order contains no explicit allegation that any order was filled at a price worse than the National Best Bid or Offer (NBBO).<sup>3</sup>

The Settlement Order also states that the Firm improperly delayed the execution of certain market orders.

The Settlement Order also describes alleged deficiencies in the processes for changing and reviewing the Firm's technology related to its market-making activities.<sup>4</sup> According to the Settlement Order, the Firm's compliance department was not sufficiently involved in reviewing programming changes to monitor for adherence to the firm's policies and procedures. Following its own discovery of the technological problems causing the alleged violations, the Firm changed the relevant programming, performed an internal investigation, and enhanced supervision and controls over the relevant trading technology.<sup>5</sup>

MS & Co., which agreed to pay almost \$6.5 million in disgorgement and prejudgment interest as well as a civil penalty of \$1.5 million, did not admit or deny the Commission's findings in connection with the settlement. The Firm also agreed to retain an Independent Compliance Consultant to review the Firm's automated retail order handling practices for compliance with the duty of best execution, as well as an Independent Distribution Consultant to develop a plan for the distribution of the disgorgement required by the Settlement Order.<sup>6</sup>

## II. Coordination Among Departments

The Settlement Order alleges that the Firm had deficient processes for implementing and reviewing changes to the Firm's market-making systems, which the Settlement Order describes as producing repeated best execution failures as well as violations of the Firm's internal policies and procedures. This aspect of the Settlement Order highlights the importance of designing and implementing processes to coordinate the activities of business, technology, legal, and compliance personnel.<sup>7</sup>

As evidenced by the Settlement Order, broker-dealers need to:

- A. Define clearly their processes for implementing new systems or making changes to existing systems.
- B. Incorporate in these processes express approval requirements to ensure consistency with legal and regulatory requirements, as well as with internal compliance policies and procedures.
- C. Ensure that all departments and individuals involved in such changes are familiar with the protocol

for making changes, including who is responsible for ensuring that the compliance department has reviewed and approved the changes.

- D. Periodically review actual operation and use of systems for potential compliance issues that may not have been foreseen.

Insufficient coordination and/or insufficient clarity in these processes may have significant consequences for a firm. For example, it may:

1. Impair the compliance department's ability to perform its oversight functions, including identifying potential inconsistencies between policies and procedures and actual firm practices (e.g., because it is not fully informed of new developments, or because it does not fully understand the functioning of certain technological tools).
2. Lead to repeated violations due to the automated functions that have not been vetted by appropriate compliance personnel.
3. Result in delayed detection and resolution of compliance problems.
4. Contribute to a general perception by regulators that the firm lacks a solid "culture of compliance."<sup>8</sup>
5. Cause regulatory violations to be aggravated by charges that the firm failed to supervise its employees and/or that the firm failed to observe and enforce its own policies and procedures.<sup>9</sup>

## III. The Basis for MS & Co.'s Liability: Best Execution and Riskless Principal Trading

- A. Basis of Liability: The Firm's Own Doing or Applicable Regulations?

The alleged violations involved the retention of the difference between the prices the Firm, acting as a market maker, obtained in Street executions and the prices at which it filled corresponding retail orders, including orders routed to the Firm by other retail broker-dealers—in other words, the retention of a profit on riskless principal trades. The Settlement Order treats this practice as violating the duty of best execution. The Settlement Order is not clear as to the basis of MS & Co.'s liability, however, especially with respect to routed orders. In this context, two questions arise. First, what gave rise to a duty of best execution to the routed

orders?<sup>10</sup> Second, assuming a duty of best execution existed for routed orders, what was the basis for including in this duty an obligation to refrain from retaining a profit on riskless principal trades?

In the factual discussion, the Settlement Order states that the Firm disclosed to “certain” non-affiliated retail brokers that it would seek to obtain best execution for routed orders and that it would not charge any mark-up, etc., for such orders. An understanding between broker-dealers that one will provide best execution to the other’s routed orders may have given rise to a duty of best execution on the part of the receiving broker-dealer.<sup>11</sup> However, the Settlement Order does not distinguish between orders received from firms to which this disclosure was made, and orders from other firms to which this disclosure was not made. The Settlement Order also states that MS & Co.’s internal procedures required it to fill customer orders at the prices it received from the Street. However, orders received from affiliates or from third-party broker-dealers are not orders from the Firm’s customers, but from other broker-dealers’ customers. Thus, it is not clear how the Firm’s policy would have applied to these routed orders. On this point, the Settlement Order asserts, without explanation, that “[t]his policy was not limited to orders received from [the Firm’s own retail] customers.”<sup>12</sup> However, the Settlement Order does not describe the basis for concluding that routed orders should be considered customer orders for purposes of MS & Co.’s policies.

Moreover, the SEC’s legal discussion does not point to either the Firm’s policies and procedures, or the Firm’s disclosures, as the basis for liability. Rather, the Settlement Order cites certain cases, including *Newton v. Merrill Lynch Pierce Fenner & Smith*,<sup>13</sup> as standing for the proposition that broker-dealers have a duty of best execution to customers, the failure of which may constitute a violation of Section 15(c)(1)(A) of the Exchange Act.<sup>14</sup> In listing the facts supporting this conclusion, the Commission states that the Firm’s “mark-ups” were undisclosed, but does not purport to rely on the fact that MS & Co. made certain express disclosures that no mark-up, commission, or other fee would be charged. As such, it is difficult to draw any conclusion from the Settlement Order about the extent to which the SEC was driven by the Firm’s specific policies and disclosures, or whether the SEC would have brought the case on general legal principles, even without the express statements about mark-ups, etc., in the firm’s policies and in its disclosures to certain unaffiliated third-party broker-dealers. In any event, a violation of the internal policy

cannot in and of itself constitute a violation of a duty under applicable laws and regulations to provide best execution or to observe restrictions on riskless principal trading, as the parameters of such duties are subject to articulation by the securities regulators and not the entities they regulate. As such, it is necessary to explore the regulatory background of riskless principal trading by market makers.

## B. A Brief Regulatory History

In 1995, the SEC, setting aside a finding by the National Association of Securities Dealers, Inc. (NASD), held that market makers may compute mark-ups from the offered side of the market when executing trades on a riskless principal basis, as trading in that manner “is part of a market maker’s normal function.”<sup>15</sup> As such, the difference between the price at which the market maker bought and the price at which it sold (exclusive of the mark-up) would not need to be disclosed or included in the calculation of the mark-up.<sup>16</sup> As further noted in that matter, SEC Rule 10b-10 (the confirmation rule) does not require market makers to disclose the difference between their buy and sell prices on riskless principal trades. Rather, 10b-10 requires market makers in equity securities to disclose the price reported to the consolidated tape and any mark-up in addition to that price.<sup>17</sup> Similarly, in 1995, the NASD issued Notice to Members 95-67, which stated that members were not precluded from executing and reporting trades on a “net” basis, i.e., on a riskless principal basis at different prices without express disclosure of the difference.<sup>18</sup>

In 1997, the NASD issued Notice to Members 97-57, interpreting the SEC Order Handling Rules<sup>19</sup> to require broker-dealers to cross limit orders received from another member with market orders (or vice versa) if the receiving broker and sending broker have an understanding that the receiving broker will provide best execution to those routed orders.<sup>20</sup>

In 1999, the NASD issued Notice to Members 99-65, which, for the first time, created a presumption that the two legs of a riskless principal trade in an equity security should be executed at the same price, unless an institutional customer specifically requested that the trade occur on a net basis.<sup>21</sup> This guidance, which became effective in early 2001, may be read as a break with the prior precedent that permitted market makers to effectively earn a bid-offer spread on many riskless principal trades. As such, the guidance contained in Notice to Members 99-65 restricted the ability of market makers to earn a spread on riskless principal trades, or trade “net.” This guidance was generally viewed

as applicable to a member's own customer's orders, not to orders routed from other members.

In 2006, the NASD implemented new Rule 2441, which in substance incorporated the prior guidance on riskless principal trading.<sup>22</sup> Under Rule 2441 (net trading rule), a member trading for or with a non-institutional customer on a net basis must provide disclosure to the customer and obtain the customer's written consent to trade on a net basis prior to each such transaction.<sup>23</sup> Consistent with the prior understanding, the NASD stated in its Notice to Members following adoption of Rule 2441 that the net trading disclosure and consent requirements do not apply to orders a member firm receives from another member or other registered broker-dealer.<sup>24</sup> The Notice to Members draws no distinction between customer and non-customer orders received from other broker-dealers. The NASD's final filing amending the rule proposal prior to its approval seems to suggest that the statement in the Notice to Members should be read to exclude—as it does on its face—all orders “received” from another broker-dealer, including routed retail customer orders.<sup>25</sup> The Commission's language in the order approving the rule is less clear on this point, which may leave some uncertainty regarding the intended scope of the rule for routed orders.<sup>26</sup> The Commission's express statement that a recipient broker-dealer has no disclosure and consent obligations to the customer of a routed order marked “net” leaves open the question of whether a recipient broker-dealer has disclosure or consent obligations for routed customer orders that are not so marked.

Also in 2006, the NASD amended its “best execution rule,” NASD Rule 2320(a), to make it applicable to customer orders an NASD member firm receives from another broker-dealer.<sup>27</sup> Thus, since the amendment's effective date, November 8, 2006,<sup>28</sup> an NASD member firm (recipient broker-dealer) has a duty of best execution with respect to customer orders received from another broker-dealer (originating broker-dealer). There is tension between a recipient broker-dealer's obligation to provide best execution to routed customer orders and the net trading guidance for orders received from other broker-dealers. The NASD also clarified in 2006 that its best execution rule applies to the bond markets as well as to the equity markets.<sup>29</sup>

Broker-dealers should also be aware that, beginning in July 2007, changes resulting from the implementation of Regulation NMS will further challenge net trading

practices. Net trading practices and best execution obligations will be complicated by the new Order Protection Rule's (OPR) treatment of net trading following amendments to Regulation NMS.<sup>30</sup> The SEC has indicated that when a transaction is effected on a net basis, the net price will be treated as the price of the trade “for all purposes under Rule 611, such as determining whether a trade-through occurred and routing the necessary orders to execute against protected quotations to comply with the ISO exception.”<sup>31</sup> To the extent that net trades occur outside the national best bid or offer, they are likely to implicate the OPR. Particularly in light of the aim of the OPR to improve the provision of best execution,<sup>32</sup> it is unclear how broker-dealers are to square this treatment of net trading with the guidance under the NASD's net trading rule and best execution rule. In addition, current programming efforts in relation to the OPR—along with the Commission's admonition that broker-dealers cannot ignore manual quotes in their best execution analyses<sup>33</sup>—reaffirm the importance of maintaining communication and coordination among legal, compliance, technology, and business personnel. On July 3, 2007, the NASD filed a rule proposal with the SEC for immediate effectiveness, to implement a mechanism to permit broker-dealers to settle transaction fees between them through a clearing report because members “indicated that upon the implementation of Regulation NMS's [OPR], many members intend to stop trading ‘net’ and begin charging an explicit transaction fee for each trade.”<sup>34</sup>

### C. The Settlement Order

The Settlement Order, which involves orders that were routed between October 24, 2001, and December 8, 2004, ignores much of the regulatory history surrounding the handling of routed orders. During the relevant period, the handling of such orders would have been governed by the principles set forth in *Strategic Resources*<sup>35</sup> and Notices to Members 97-57 and 99-65.<sup>36</sup> This guidance, read together, would have required MS & Co. to handle orders in the following ways.

When the Firm received its own customer orders and filled them by trading with the Street, it would have been required to execute the customer's order at the same price the Firm received on its execution, absent the customer's consent to trade “net.” A violation of these principles would appear to provide a basis for the findings in the Settlement Order with respect to orders from the Firm's own retail clients. However, when the Firm's affiliate or another broker-dealer routed orders to it, MS & Co. would

only have had an obligation to trade without a spread if: (1) it had an arrangement with the other broker-dealer; and (2) it was crossing market orders with limit orders. While the Settlement Order discusses facts that may constitute such an arrangement with respect to at least some of the routing broker-dealers, it does not make any explicit statement that such an arrangement, as contemplated by Notice to Members 97-57, in fact existed. Moreover, the Settlement Order does not distinguish between limit and market orders.<sup>37</sup> Further, at the time of the trades, the NASD best execution rule did not require firms to provide best execution to routed orders, and to this day NASD guidance permits net trading of routed orders. As such, the regulatory basis for a finding that the Firm's order handling practice violated best execution principles, with respect to routed orders, is unclear and seems inconsistent with the then-existing precedent.<sup>38</sup>

Further, the SEC's decision may derive from its broad reading of the *Newton* decision.<sup>39</sup> Specifically, the Commission apparently reads *Newton* as holding that a broker-dealer has a duty "to maximize the economic benefit to its customers"<sup>40</sup> irrespective of whether the broker-dealer is acting as a market maker and thus is entitled to a spread both in terms of sound economics and consistent with the principles stated by the Commission in *Strategic Resources*.<sup>41</sup> Whatever the SEC's rationale, however, the potential for the case to be read in this manner is troubling, not least in the context of bond trading, where net, riskless principal trades may play an important part in certain segments of the market.<sup>42</sup>

Another puzzling feature of the Settlement Order is footnote number four, which states that in 2001, the NASD "permitted broker-dealers to embed undisclosed mark-ups and mark-downs (i.e., trade on a net basis) on institutional orders provided that the institutional customers consented."<sup>43</sup> By the reference to 2001, it is clear that the Settlement Order is referring to the guidance contained in Notice to Members 99-65. However, that guidance **restricted** net trading that had previously been viewed as acceptable; it is quite odd, to say the least, to describe that guidance as **permitting** net trading. In sum, the failure of the Settlement Order to adequately grapple with the regulatory history of riskless principal trading, net trading, and best execution leaves significant uncertainty about the regulatory basis for its conclusions.

#### IV. Potential Lessons to be Drawn

Given the failure of the Settlement Order to adequately address the regulatory history of riskless principal trading, there are several potential lessons that may be drawn, although the extent to which the Commission intended these lessons is unclear.

First, to the extent firms implement policies and procedures, or enter into contracts with (or make other disclosure to) counterparties, firms should have a mechanism to monitor for adherence to these commitments, as regulators may seek to leverage breaches into regulatory violations.

Second, in connection with any net trading practices, or similar trading practices, firms need to focus on the disclosure they are providing to the broker-dealers that may be routing orders to them, and order routing brokers need to focus on disclosures to their customers.

Third, it is interesting to consider the application of the Settlement Order to riskless principal trading in the bond markets. To the extent the case stands for the proposition that riskless principal trades on a net basis, i.e., with undisclosed spreads, violate principles of best execution, the NASD has explicitly stated that best execution rules are applicable to the bond market, and the SEC seems to believe that net trading is prohibited unless the NASD has given "permission," what disclosures should a dealer contemplate in connection with riskless principal bond market trades? SEC Rule 10b-10, the trade confirmation rule, does not require dealers to disclose mark-ups or mark-downs to customers. Similarly, however, SEC Rule 10b-10 did not require the Firm to disclose mark-ups on routed orders (as there is no 10b-10 obligation between dealers). Further, as the Settlement Order did not allege any violation of SEC Rule 10b-10 in the trades between the Firm and its own customers, presumably the Firm complied with 10b-10's requirement that a market maker in an equity security confirm to the client the reported price. Thus, compliance with SEC Rule 10b-10 may not provide a defense for a dealer that does not disclose a spread (or at least the fact that a spread may be charged) on riskless principal trades in the debt markets.

Fourth, the Settlement Order may be read to further chip away at a market maker's ability to take a dealer's spread on a riskless principal trade, an ability that will be

further eroded by Regulation NMS. As such, Firms should review their net trading practices in light of Regulation NMS.

## V. Conclusion

The Settlement Order highlights the ongoing challenge broker-dealers face to establish and maintain policies and procedures that provide appropriate legal and compliance involvement in changing technology and business practices. The difficult task of maintaining effective channels of communication and coordination among legal, compliance, technology, and business departments demands close attention. The Settlement

Order's treatment of net trading practices and the duty of best execution further emphasizes the need for firms to evaluate their practices under new and revised rules and make careful judgments about how best to fulfill their regulatory obligations.

Achieving coordinated and consistent resolution of the various issues raised by these recent developments provides significant challenges to firms—at least until the regulators provide additional guidance regarding the apparent tensions among the various regulatory obligations.

## NOTES

1. See Exchange Act Release No. 55,726 (May 9, 2007) (Settlement Order).
2. The Settlement Order states that MS & Co. mainly served institutional customers during the relevant time period, although it also executed some orders for retail customers of its Private Wealth Management unit and executed routed orders. Settlement Order at ¶8. The Settlement Order does not provide a breakdown of the origin of the orders. It appears, however, that the alleged conduct involved primarily routed orders. It is unclear whether the fact that some of the orders originated with an affiliate affected the SEC's evaluation of the alleged conduct.
3. The Settlement Order describes systems that allegedly caused orders to be executed at the NBBO when the Firm executed on the Street a corresponding order for its own account at a superior price. Settlement Order at ¶¶17, 22-23. Certain language may imply that some orders were filled at a price inferior to the current NBBO. Specifically, the Settlement Order states that, for certain orders, a programming code compared the Firm's execution on the Street with the NBBO at the time of comparison, which occurred after the Street execution. If the Street execution price was better than the NBBO, the Firm allegedly executed the customer order at the NBBO and retained the difference between the two prices. The Settlement Order further notes that even a small time lapse between the Street execution and the comparison could allow for changes in the NBBO. *Id.* at ¶¶21-23. According to the Settlement Order, this time lapse meant that "the Code not only prevented certain retail customers from receiving the benefit of superior Street Executions, it also sometimes resulted in customers receiving prices worse than what was reasonably available at the time of execution." *Id.* at ¶23 (emphasis added). The Settlement Order fails to specify, however, how the programming code produced the result described in the latter part of the quoted sentence, including whether it refers to prices inferior to the NBBO.
4. Settlement Order at ¶¶25-35.
5. Settlement Order at ¶¶36, 39.
6. The fact that some of the customers due a portion of the disgorgement amount are customers of originating broker-dealers, rather than customers of MS & Co., has the potential to complicate development and administration of a distribution plan. For example, MS & Co.'s records may

not contain all necessary information with respect to these customers, in which case the Firm and its Independent Distribution Consultant would need to obtain information from the originating broker-dealers.

7. For further discussion of this concern, including regulators' focus on it as evidenced in enforcement actions, see Recent Enforcement Actions Target Broker-Dealer Operational and Systems Issues (WilmerHale Securities Briefing Series) Jan. 2006, available at [www.wilmerhale.com](http://www.wilmerhale.com).
8. This term has become a common theme among SEC staff in recent years. Lori Richards, for example, has described a good "culture of compliance" as consisting of five elements:

First, it has a strategic vision. Compliance activities have to relate to some larger strategic goal. Second, it identifies the specific risks that could arise within each strategic area. The devil, as they say, is in the details. Third, it establishes control points for each of these risks. Fourth, it is well documented. Documentation provides transparency, both internal, to senior management, and external, to auditors and regulators. Fifth and finally, specific people are accountable for managing each specific element of the compliance system. You can have the best policies and procedures in the world, but if no one is making them work, they will be useless.

Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, Remarks at the Spring Compliance Conference: National Regulatory Services (Apr. 23, 2003). Richards also has referred to a "process of compliance," which should "serve to help the firm avoid violations, and help the firm to detect violations and deal with them effectively." Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, "The Process of Compliance," Remarks at National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006).

9. Note, for instance, that MS & Co. faced fraud charges and a substantial fine, despite the Firm's eventual detection and correction of faulty programming features. The Settlement Order states that the Firm failed to prevent the problems or correct them in a timely manner.
10. The NASD's best execution rule, NASD Rule 2320(a), did not apply to routed orders at the time of the alleged violations. See *infra*.
11. See NASD Notice to members 97-57 (Sept. 1997).

12. Settlement Order at ¶11.
13. *Newton v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 135 F.3d 266 (3rd Cir. 1998) (en banc).
14. Settlement Order at ¶37 nn.10-11.
15. *In re Strategic Res. Mgmt., Inc.*, Exchange Act Release No. 36,618, 60 S.E.C. Docket 2493 (Dec. 21, 1995) (Opinion of the Commission).
16. *Id.*
17. SEC Rule 10b-10(a)(2)(ii).
18. NASD Notice to Members 95-67 (1995). In 1994, the NASD implemented its “Manning” rules, requiring market makers to protect customer limit orders. In 1995, the NASD expanded its “Manning” rules to require market makers to protect routed limit orders. NASD Notice to Members 95-43 (1995). “Manning” principles were expanded to cover market orders after the events in this matter. *See* Settlement Order at ¶ 34 n.9.
19. Formerly SEC Rules 11Ac1-4 and 11Ac1-1, now part of Regulation NMS.
20. NASD Notice to Members 97-57 (Sept. 1997).
21. NASD Notice to Members 99-65 (Aug. 1999). This presumption was announced in the context of a change to the NASD’s trade reporting rules. The change was designed to reduce fees charged under Section 31 of the Securities Exchange Act and to limit the double-counting of volume for trades executed in the over-the-counter market. Cf. *In the Matter of Richardt-Alyn & Co.*, Richard B. Feinberg and Alan S. Feinberg, Initial Decision, 70 SEC Docket 1703-199 (Sep. 30, 1999) (non-market maker may not retain undisclosed trading profits in trades with its own customers, but similar conduct with respect to routed orders does not violate anti-fraud provisions).
22. Exchange Act Release No. 54,088 (June 30, 2006), 71 Fed. Reg. 38,950 (July 10, 2006) (approving new NASD Rule 2441).
23. NASD Rule 2441(a)-(b). For purposes of Rule 2441, a “net” transaction is “a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.” NASD Rule 2441(e).
24. *See* NASD Notice to Members 06-47 (Sept. 2006) (stating that “Rule 2441 does not apply to orders received from member firms and other registered broker-dealers”).
25. Addressing the question of orders received from other broker-dealers, the NASD explained:
- One of the commenters requested clarification as to whether the proposed consent and disclosure requirements apply to orders received from members and other registered broker-dealers. In addition, the commenter requested clarification that a receiving broker-dealer handling an order marked “net” routed to it from an originating broker-dealer would not have consent and disclosure obligations to the customer of the originating broker-dealer. *NASD is clarifying that the proposed rule change does not apply to orders received from member firms and other registered broker-dealers. Accordingly, the proposed rule change would not apply to the receiving broker-dealer in either of the scenarios noted by the commenter*, consistent with the application of customer confirmation requirements under SEC Rule 10b-10. Rather, the originating broker-dealer would be responsible for meeting the proposed requirements. NASD notes, however, that the receiving broker-dealer may have other obligations to that order pursuant to other NASD or SEC rules.
- Amendment No. 4, Disclosure and Consent Requirements When Trading on a Net Basis With Customers, File No. SR-NASD-2004-135 (Sept. 13, 2005), at 10-11, *available at* [www.nasd.com](http://www.nasd.com) (emphasis added). Use of the term “accordingly” supports the conclusion that the routed order scenario is outside the scope of the rule because all orders received from other members or registered broker-dealers are outside the scope of the rule.
- Note also that proposed Rule 2441 was under consideration at the same time as the amendments to make the best execution rule applicable to routed customer orders. Yet the NASD chose to make the net trading rule applicable to net transactions “for or with a customer”—the same language used in the best execution rule *before* the 2006 amendments.
26. The approval order states:
- NASD clarified that the scope of the proposal does not include orders received from member firms and other registered broker-dealers. As such, the proposal would not apply to orders received from members and other registered broker-dealers, nor would a receiving broker-dealer handling an order marked “net” routed to it from an originating broker-dealer have consent and disclosure obligations to the customer of the originating broker-dealer. In both scenarios, the originating broker-dealer would be responsible for adhering to the requirements.
- 71 Fed. Reg. 38,950, 38,952 (footnote omitted). The word “nor” and the phrase “both scenarios” would seem to suggest two independent alternatives (i.e., orders received from members and other registered broker-dealers, and routed orders marked “net”), and yet the more general reference to orders received from other broker-dealers would seem to include routed orders. The decision—by both the NASD and the SEC—to address both the general and the specific question appears to stem from the fact that a commenter requested clarification with respect to both questions.
27. Exchange Act Release No. 54,339 (Aug. 21, 2006), 71 Fed. Reg. 50,959 (Aug. 28, 2006). For a discussion of the changes made by these amendments, see Soo J. Yim and Christie Farris Öberg, *NASD Expands Broker-Dealer’s Duty of Best Execution*, *J. Inv. Compliance*, Jan.-Mar. 2007, at 25.
28. NASD Notice to Members 06-58 (Oct. 2006).
29. *See* NASD IM-2320; NASD Notice to Members 06-58 (Oct. 2006). For an example of recent regulatory scrutiny of best execution practices in the fixed income context, see News Release, NASD, *NASD Fines HSBC Brokerage for Failure to Supervise Government Securities Transactions for Best Execution* (May 29, 2007) (describing alleged violations of best execution rule, as well as lack of adequate supervisory review for best execution, by a broker-dealer that routed trades in government securities to an affiliated broker-dealer).
30. The Order Protection Rule, 17 C.F.R. §242.611 (2006), aims to prevent trade-throughs by establishing intermarket price protection for automated quotations in NMS stocks displayed by automatic trading centers that are at the top-of-the-book (best bid or offer) of an exchange or the NASD’s Alternative Display Facility. July 9, 2007 was the “Pilot Stocks Phase Date,” starting on which compliance with the Order Protection Rule was required with respect to 250 NMS stocks. August 20, 2007 is the “All Stocks Phase Date,” on which trading in all other NMS stocks will become subject to the rule. Exchange Act Release No. 55,160 (Jan. 24, 2007), 72 Fed. Reg. 4202 (Jan. 30, 2007) (altering Regulation NMS implementation dates).
31. Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, Questions 3.05, 3.07 and 3.16 (updated June 8, 2007), *available at* <http://www.sec.gov/divisions/market-reg/nmsfaq060807.htm>.
32. The SEC stated this goal repeatedly in its adoption release. *See, e.g.*, Exchange Act Release No. 51,808 (June 9, 2005), 70 Fed. Reg. 37,496, 37,516 (June 29, 2005) (“The Order Protection Rule will backstop a broker’s duty of best execution on an order-by-order basis by prohibiting the practice of executing orders at inferior prices, absent an applicable exception.”).
33. 70 Fed. Reg. 37,496, 37,537 (“The Commission therefore is not at this time excluding manual quotations from the NBBO or from the benchmark used for calculating execution quality statistics under Rule 605. The Commission continues to emphasize that adoption of Rule 611 in no way lessens a broker-dealer’s duty of best execution.”).
34. Exchange Act Release No. 56,007 (July 3, 2007), 72 Fed. Reg. 37,807 (July 11, 2007) (approving for immediate effectiveness SR-NASD-2007-046). The “Explicit Fee” field implementing this change became available on the ACT system on July 9, 2007. *See* “Processing of Transaction Fees through the NASD/NASDAQ Trade Reporting Facility,” NASD Member Alert (July 3, 2007) (announcing the change and the implementation date); Nasdaq Head Trader Alert 2007-141 (July 2, 2007) (same). The rule change applies only to transactions between NASD members, not to a member’s transactions with customers.
35. *Supra* n.15.

36. *Supra* nn.11 & 21.
37. For this reason, too, the NASD's Manning rules do not appear to have had an impact on the SEC's decision to institute proceedings.
38. It may be the case that the SEC felt that under the principle announced in Notices to Members 97-57 and 99-65, the Firm should have treated orders routed from its affiliate as its own orders. While this may be a reasonable position, it is not actually stated in the Settlement Order and in any event would not at all address orders routed to the Firm from unaffiliated broker-dealers.
39. *See Newton*, 135 F.3d 266.
40. Settlement Order at ¶37 n.10.
41. *See Strategic Resources*, Exchange Act Release No. 36,618.
42. Indeed, we have been unable to locate support for it in any of the citations in the "Legal Discussion" section of the order. Note, for instance, that the Settlement Order's characterization of *Geman v. SEC*, 334 F.3d 1183, 1192-93 (10th Cir. 2003), is inaccurate. *See* Settlement Order at ¶37 n.10. The Settlement Order describes this case as "finding that broker-dealer violated its duty of best execution by failing to disclose that its method of executing orders deprived customers of the possibility of getting a price better than the NBBO." *Id.* In fact, the cited case, which involved a non-market maker that failed to disclose it was trading on a principal basis, states that deficient records prevented the Commission from determining whether best execution was provided, although the court affirmed the SEC's determination of other violations. *Geman*, 334 F.3d at 1185 n.1; 1193. *See also* *In re Marc N. Geman*, Exchange Act Release No. 42,963, 2001 WL 124847, at \*12-\*15 (Feb. 14, 2001) (underlying SEC decision discussing allegations of best execution violations and concluding that such violations had not been proven, in part due to broker-dealer's failure to record execution times).
43. Settlement Order at ¶2 n.4.

FOR MORE INFORMATION ON THIS OR OTHER SECURITIES MATTERS, PLEASE CONTACT:

<b>Brandon Becker</b>	brandon.becker@wilmerhale.com	+1 202 663 6979
<b>Bruce H. Newman</b>	bruce.newman@wilmerhale.com	+1 212 230 8835
<b>Andre Owens</b>	andre.owens@wilmerhale.com	+1 202 663 6350
<b>Soo J. Yim</b>	soo.yim@wilmerhale.com	+1 202 663 6958