
NASD Expands Broker-Dealer's Duty of Best Execution

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Introduction

On August 21, 2006, the Securities and Exchange Commission (the Commission) approved amendments to NASD Rule 2320(a), commonly known as the "best execution rule."¹ Under the best execution rule, a member first must use "reasonable diligence" to learn the best market for a security that is the subject of a customer order, and then must buy or sell in that market to obtain for the customer the best price possible under prevailing market conditions. Adoption of the rule change occurred after several iterations and some controversy regarding the scope of the rule. Most significantly, the amendments make the rule applicable to "any transaction for or with a customer **or a customer of another broker-dealer**," (emphasis added) thus imposing the duty of best execution on a member that executes a customer order received from another broker-dealer. The NASD also has reiterated that debt transactions are subject to the rule. In addition, the rule amendments update certain language and add new Interpretive Material regarding certain aspects of the rule.²

Effective Date

The NASD is expected to publish a Notice to Members within 60 days of the Commission's approval, i.e., by October 20, 2006. The effective date of the amendments will be 30 days following publication of the Notice to Members.³

Scope of the Best Execution Obligation

Recipient Broker-Dealers

In its current form, the best execution rule applies to a member's transactions "for or with a customer." NASD Rule 0120(g) excludes broker-dealers from the definition of "customer," unless the context requires otherwise. Questions have arisen regarding whether and how the best execution rule applies to a member ("recipient broker-dealer") that receives a customer order from another broker-dealer ("originating broker-dealer") for execution. The issue was whether it was consistent with NASD rules for the recipient broker-dealer to take the position that it had no duty of best execution because it was transacting for or with **a broker-dealer**, rather than "for or with **a customer**" (emphasis added).

As amended, the rule requires a member to seek best execution for "any transaction for or with a

customer **or a customer of another broker-dealer**" (emphasis added), making the duty of best execution explicitly applicable to the recipient broker-dealer. The NASD has taken the position that the general intent of the rule and the best interests of investors require its application to all customer orders, regardless of their origin.⁴ However, a recipient broker-dealer has a best execution obligation **only if** it receives the customer order for handling and execution, **and not if** the originating broker-dealer is executing the customer order against the recipient broker-dealer's quote.⁵

Under the amended rule, a recipient broker-dealer's compliance with the terms and conditions of the customer order as communicated to it by the originating broker-dealer is **not** sufficient to constitute "reasonable diligence."⁶ Instead, such compliance is just one of several factors relevant to a best execution determination. The Commission states in the Approval Order that compliance with the terms and conditions of the customer order should be a "significant" factor—but not the "sole" factor—in determining whether the recipient broker-dealer has fulfilled its duty of best execution.⁷

An originating broker-dealer remains obligated under the rule, regardless of whether it has routed a customer order to another member for execution.⁸

Debt Transactions

The Bond Market Association (BMA) submitted comment letters that challenged certain aspects of the rule amendments, stating that some changes were inappropriate for the bond markets.⁹ The BMA argued that more specific guidance was necessary regarding which debt transactions are subject to the rule and how bond market participants should discharge their responsibilities under the rule. The BMA argued, for example, that it was unclear whether the rule applied to a customer order to buy a fixed income product with certain characteristics, rather than a specific security, and that it was unclear what constitutes a "market" for debt securities for purposes of the rule. The NASD provided some clarifications, but ultimately rejected many of the BMA's arguments, and the Commission agreed that the best execution rule currently applies to debt transactions and noted the NASD's clarification regarding the rule's application to debt transactions. The Commission stated that it expects the NASD to "take into account the structure and operation of the debt markets" when applying the rule to debt transactions.¹⁰ It remains to be seen, however, whether additional guidance will be provided concerning how to assess best execution in highly illiquid markets (such as certain distressed bonds and structured debt products) in which only one or two dealers may be willing or able to transact.

Factors Relevant to a Best Execution Determination

The best execution rule requires a member to use "reasonable diligence" to learn the best market¹¹ for a security that is the subject of a customer order and to buy or sell in that market to obtain for the customer the best price possible under prevailing market conditions. The rule includes a non-exclusive list of five factors relevant to the "reasonable diligence" determination. The factors in the rule as amended are:

(1) "the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on

available communications"

The amendments do not change this factor. The "character of the market" likely will be a particularly important factor in the application of the rule to fixed income transactions.

(2) "the size and type of transactions"

The amendments do not change this factor.

(3) "the number of markets checked"

The NASD first proposed to change this factor—which in the rule's current language refers to "primary markets"—to refer to "market centers." Ultimately, the NASD opted for the term "market," which it has indicated should be interpreted broadly (here and elsewhere in the rule) to include "a variety of different venues, including, but not limited to, market centers that are trading a particular security."¹² As noted above, the BMA questioned what constitutes a "market" for a fixed income security, but the Approval Order does not specifically address this issue.

(4) "accessibility of the quotation"

This factor has been shortened from the current language, "location and accessibility to the customer's broker/dealer of primary markets and quotations sources."

In the context of bonds, "quotation" means dollar (or other currency) pricing or yield pricing.¹³ The Interpretive Guidance reiterates that the accessibility of quotations is just one of the relevant factors in the rule, and that in the absence of accessible quotations, a broker-dealer must take "reasonable steps" and use "market expertise" to achieve best execution.¹⁴

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

This factor is new in the amended rule. As discussed above, the NASD has taken the position that this factor is just one among several to be considered—even where a member has received the customer order from another broker-dealer for execution.

Looking Ahead to Implementation

The Approval Order calls for a careful review by broker-dealers of their existing best execution policies and procedures. Among other things, both originating and recipient broker-dealers should consider the following areas of potential concern:

- How should the originating broker-dealer revise the factors considered in its "regular and rigorous" examination of execution quality of recipient broker-dealers to ensure that they are compatible with the factors listed in the NASD rule as amended?
- How should the recipient broker-dealer weigh the value of fast and assured executions, relative to price improvement opportunities, when handling customer orders of different originating broker-dealers?
- How should the originating and recipient broker-dealers monitor compliance with the

terms and conditions of orders placed by customers trading on a "net" basis, as distinguished from those who did not provide the requisite consent?¹⁵

- For fixed income transactions, how should broker-dealers document the "number of markets checked" to establish the reasonableness of their diligence, and what is the best way to monitor for best execution for dollar-based bonds in the absence of other reported trades or benchmark securities?
- As a matter of general business practice, under the new NASD rule, does it make more sense than ever before for the originating and recipient broker-dealers to have a written agreement specifying their respective regulatory obligations with appropriate representations and warranties?

For more information on this or other securities issues, please contact the authors listed above.

¹ Exchange Act Release No. 54,339 (Aug. 21, 2006), 71 Fed. Reg. 50,959 (Aug. 28, 2006) ("Approval Order"). Also available [here](#). The new rule language is available by clicking [here](#).

² IM-2320, [Interpretive Guidance with Respect to Best Execution Requirements](#).

³ Exchange Act Release No. 51,229 (Feb. 18, 2005), 70 Fed. Reg. 9,416 (Feb. 25, 2005) ("Proposing Release"). Also available by clicking [here](#).

⁴ In fact, the newly amended rule will apply more broadly than the NASD initially imposed. In its first iterations, the rule amendments would have imposed the best execution obligation on a recipient broker-dealer only if it had undertaken in a written agreement with the originating broker-dealer to provide best execution. See Proposing Release at 4-5.

⁵ IM-2320.

⁶ Commenters argued that compliance with the customer order's terms and conditions as communicated to it should suffice, because the recipient broker-dealer lacks a relationship with the customer and because the terms and conditions should reflect the originating broker-dealer's own best execution analysis. See [Comment Letter from Paul A. Merolla](#), Instinet Group (March 22, 2005); [Comment Letter from Amal Aly](#), Securities Industry Association (March 18, 2005). The NASD and the Commission were not persuaded by this argument. See also Comment Letters from the Bond Market Association, *infra*, note 9 (arguing against applying the rule to a recipient broker-dealer in the context of debt transactions).

⁷ Approval Order at 7.

⁸ Proposing Release, at 6 fn. 8.

⁹ The BMA's comment letters are available online: ([Nov. 16, 2005 letter](#); [Sept. 7, 2005 letter](#); [April 5, 2005 letter](#)).

¹⁰ Approval Order at 8.

¹¹ The current rule language refers to the best "inter-dealer market." The NASD had proposed to change this phrase to "market center," but later chose to use the term "market" to encompass a

broader range of trading venues. See *infra*, text accompanying note 12.

12 IM-2320.

13 IM-2320.

14 IM-2320.

15 Under new NASD Rule 2441, the originating broker-dealer would be responsible for obtaining the requisite customer consent for "net" trading. Presumably, however, at the point of execution, it would be the responsibility of the recipient broker-dealer to handle those customer orders marked "net" differently from those not marked "net," as routed to it for execution by the originating broker-dealer. See NASD Notice to Members 06-47 (Sep. 2006), available by clicking [here](#).

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