



October 2, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Response to Comments to File No. SR-NASD-2006-005 – Proposal to Expand the Scope of Rule 2440 and IM-2440

Dear Ms. Morris:

On January 19, 2006, National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) proposed rule change SR-NASD-2006-005, proposing to expand the scope of Rule 2440 and Interpretive Material (IM) 2440 relating to fair prices and commissions to apply to all securities transactions with or for a customer, whether executed over-the-counter (“OTC”) or on an exchange.

On April 4, 2006, the Commission published for comment the proposed rule change in the Federal Register.¹ The Commission received two comment letters in response to the Federal Register publication of SR-NASD-2006-005.² The commenters raised several issues relating to the proposal. NASD is hereby responding to the comments made therein.

Summary of Comments and Responses

One of the commenters raises concerns regarding issues that are not germane to the current proposal.³ Specifically, the commenter raises concerns relating to municipal

¹ See Securities Exchange Act Release No. 53562 (March 29, 2006), 71 FR 16849 (April 4, 2006) (“Federal Register Notice”).

² Comment letters were submitted by: Dan Mayfield, President, Sanderlin Securities, dated April 6, 2006 (“Sanderlin Letter”); and Mary C.M. Kuan, Vice President and Assistant General Counsel, The Bond Market Association, dated May 4, 2006 (“BMA Letter”).

³ See Sanderlin Letter.

securities. As noted in the proposed rule change, Rule 2440 and IM-2440 do not apply to transactions in municipal securities and this would not be changed by the current proposal.⁴

The other commenter generally opposes the proposed expansion of the scope of Rule 2440 and IM-2440 to all securities transactions, indicating that the proposal raises significant questions regarding a self-regulatory organization's ("SRO") jurisdictional reach.⁵ In this regard, the commenter asks whether there is a regulatory gap being addressed by the proposal and, if so, whether NASD is the appropriate regulator to address such a gap. The commenter also questions whether the proposal will create overlapping, potentially inconsistent authority between the SROs and asks whether Section 15A of the Exchange Act limits NASD authority to regulate exchange transactions.

As previously described in the proposed rule change, the current language of Rule 2440 and IM-2440 limits their application to OTC transactions. However, NASD has taken the position that a broker-dealer charging excessive compensation in a transaction with a customer executed on an exchange violates Rule 2110, which requires that a member, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."⁶ The proposal seeks to clarify and codify that the standards set forth in Rule 2440 and IM-2440 apply uniformly to all securities transactions by members, irrespective of whether the transaction is ultimately executed OTC or on an exchange.

As such, NASD believes the commenter's assertion that this proposal implicates NASD's jurisdictional reach is misguided. NASD has previously and appropriately regulated charges imposed by members on their customers relating to exchange transactions under Rule 2110.⁷ Contrary to the commenter's characterization, NASD's proposal is not attempting to regulate the "pricing of transactions effected on an exchange;" rather NASD's proposal restricts charges imposed by members on their customers, irrespective of where the transaction is executed.

⁴ See Federal Register Notice at footnote 5.

⁵ See BMA Letter.

⁶ See NASD Rule 2110. See also Atlanta-One, Inc. v. SEC, 100 F.3d 105, 107 n.1 (9th Cir. 1996), which states "[a]lthough [Rule 2440 and IM-2440] deals with the appropriate level of compensation in retail transactions in the over-the-counter market, the [rule] provides guidance by analogy as to appropriate commissions for exchange transactions."

⁷ Id.

As a national securities association registered with the Commission under Section 15A of the Exchange Act, NASD is responsible for enforcing compliance with its own rules, the federal securities laws and the rules of the MSRB.⁸ NASD has broad regulatory responsibility regarding its members' activities with customers, including that NASD's rules 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.⁹ The scope of the NASD's regulatory jurisdiction clearly is not limited to OTC trading, but extends to its members conduct with customers relating to trading on all markets, as applicable.¹⁰

NASD believes that Rule 2440 and IM-2440 relating to fair prices and commissions foster essential investor protections that should be uniform and not vary based on where the member's customer order ultimately is executed. Ensuring fair prices is critical to the integrity of securities markets and the continued confidence that investors place in those markets. NASD believes the proposed rule change furthers these important objectives.¹¹

With respect to the commenter's concern about potential regulatory overlap and duplication, NASD believes that comment also is misguided. As a technical matter, NASD does not believe that the proposal constitutes duplicative regulation given that NASD is not aware of any exchange rules that impose similar fair pricing standards. However, in any event, whether another SRO has established rules relating to a member's conduct would not preclude NASD from proposing rules in that same area. While NASD

⁸ See Section 15A(b)(2) of the Exchange Act. See also Section 19(g)(1) of the Exchange Act, requiring, among other things, that every SRO examine for, and enforce compliance by, its members and persons associated with its members with the Exchange Act, the rules and regulations thereunder, and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Sections 17(d) or 19(g)(2) of the Exchange Act.

⁹ See Section 15A(b)(6) of the Exchange Act.

¹⁰ See SEC Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) ("whether or not the transactions were traded over-the-counter or consummated on an organized exchange does not alter the fact that the member or registered representative in the course of its business has an obligation to live up to high standards of commercial honor and just and equitable principles of trade." (quoting a 1961 NASD Board of Governors decision)).

¹¹ See S. Rep. No. 75, 94th Cong., 1st Sess. 48, reprinted in 1975 U.S. Code Cong. & Admin. News 1979, 206 (in establishing Section 15A of the Exchange Act, Congress stated that the power of an SRO to protect investors against "gouging" and overreaching with respect to commissions and other fees is complete and effective by virtue of the requirement that SRO rules be designed to promote just and equitable principles of trade). See also H.R. Rep. No. 2307, 75th Cong., 3d Sess. 8 (1938) ("[I]t is contemplated that associations may adopt rules designed to prevent each member thereof from exacting in any particular transaction a profit which reasonable men would agree was unconscionable in the light of all of the concrete facts and circumstances of that transaction; . . .").

certainly endeavors to reduce regulatory duplication where possible, some overlap is inevitable in a structure with multiple SROs.¹²

The commenter also inquires how the costs of NASD's regulation of exchange transactions will be allocated, including as to non-NASD member firms, and raises the concern that the proposal will be used to justify an increase in NASD regulatory fees. NASD does not intend to change its current methodology for imposing and collecting regulatory fees on its members as a result of this proposal and NASD does not impose regulatory fees on non-members, nor would the scope of the rule extend to non-members.

The commenter also proposes as an alternative approach to the proposed rule change that the Commission require NASD to enter into agreements pursuant to Section 17(d) of the Exchange Act and Rule 17d-2 thereunder with the exchanges to minimize duplicative regulation. Section 17(d) of the Exchange Act¹³ and Rule 17d-2 thereunder¹⁴ address common rules applicable to members that belong to more than one SRO. In the current instance, there are no common rules: NASD is not aware of rules of other exchanges substantially similar to Rule 2440 and IM-2440. As such, the commenter's suggestion regarding the use of such agreements is not applicable in this context.

The commenter also asks for further explication of the proposal. Specifically, the commenter inquires as to how NASD would apply Rule 2440 and IM-2440 to an exchange market. NASD will apply Rule 2440 and IM-2440 in the same manner as it does today and will apply it uniformly to its members, irrespective of whether the customer's transactions ultimately are executed OTC or on an exchange.

Interestingly, the commenter's concerns focus on jurisdictional and procedural issues and do not raise any substantive objections as to why the fair pricing standards set forth in Rule 2440 and IM-2440 should not apply to transactions executed on an

¹² In this regard, the commenter also expresses a desire for regulatory rationalization of the SRO system generally. NASD believes these comments are outside the scope of this proposed rule change. As the commenter is well aware, the Commission currently is undertaking a comprehensive review of the SRO system. See Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) (File No. S7-40-04).

¹³ Pursuant to Section 17(d) of the Exchange Act, when a member belongs to more than one SRO, the SEC may designate the responsibility to one SRO for examining the member for compliance with applicable rules. The undesignated SRO is relieved of responsibility for examining the member for compliance with such rules.

¹⁴ Rule 17d-2 under the Exchange Act permits SROs to establish Commission approved joint plans for allocating regulatory responsibilities with respect to common members. An SRO participating in such a regulatory plan approved by the Commission is relieved of regulatory responsibilities with respect to a broker-dealer member, if those regulatory responsibilities have been allocated to another SRO under the regulatory plan.

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exchange. NASD believes that is because there is no rational reason why such standards should not apply equally to transactions executed on an exchange or OTC.

In concluding its letter, the commenter argues that the Commission should not approve the proposal absent (1) a stated justification of the existing regulatory gap; (2) a plan to eliminate duplicate regulation by exchanges and NASD; (3) a plan to eliminate duplicative regulatory costs; and (4) a clear statement of NASD's authority to regulate exchange transactions under Section 15A of the Exchange Act.

While NASD believes it has responded to the four issues noted above, our response should not be construed as concurrence with the commenter's assertion that SEC approval of this filing should be contingent upon resolution of such issues. NASD strongly disagrees with that proposition. Rather, the standards that NASD must satisfy in any proposed rule change are set forth in Sections 15A and 19(b) of the Exchange Act. Section 15A(b)(6) of the Exchange Act requires, among other things, that NASD rules 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. Section 19(b)(2) of the Act provides that the Commission shall approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and rules and regulations thereunder. As stated in Section 3(b) of the proposed rule change, NASD believes it has made the requisite showing.

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NASD believes that the foregoing responds to the material issues raised by commenters to this rule filing. If you have any questions, please contact Andrea Orr at (202) 728-8156; email: andrea.orr@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,



Stephanie M. Dumont
Vice President and
Associate General Counsel

cc: Joseph P. Morra (SEC, Division of Market Regulation)