

## INFORMATIONAL

## Best Execution

NASD Regulation  
Reiterates Member  
Firm Best Execution  
Obligations And  
Provides Guidance To  
Members Concerning  
Compliance

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representative
- Legal & Compliance
- Senior Management

## KEY TOPICS

- Best Execution

### Executive Summary

The National Association of Securities Dealers, Inc. (NASD® or Association) is issuing this *Notice* to reiterate the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and to provide guidance to members concerning a broker/dealer's obligation, as articulated on numerous occasions by the Securities and Exchange Commission (SEC), to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security.<sup>1</sup> This *Notice* also discusses how recently-adopted SEC rules concerning the disclosure of order execution and routing practices will assist members in meeting their regular and rigorous examination obligation. In addition, this *Notice* includes a Question and Answer section that responds to many of the compliance questions that the NASD has received from its members concerning the regular and rigorous component of the duty of best execution.

### Questions/Further Information

If members have additional questions regarding these issues, please contact the Legal Section, Market Regulation Department, NASD Regulation, Inc. (NASD Regulation), at (240) 386-5126.

### Discussion

Compliance with a member firm's obligation to provide best execution to its customers' orders is an important focus of NASD Regulation's examination, customer complaint, and automated surveillance programs. As a result of these programs, NASD Regulation has brought disciplinary actions that

have resulted in censures, fines, and restitution to injured customers. These actions have resulted from findings that customer orders were executed: (1) at prices inferior to the national best bid and offer (NBBO) without justification; (2) in an untimely fashion; or (3) in a manner designed to allow the member firm to profit at the expense of its customer. Additionally, both the SEC and NASD Regulation conducted examinations that discovered that some member firms failed to establish procedures to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security, or developed procedures that were inadequate.<sup>2</sup>

The NASD previously has addressed best execution issues in numerous *NASD Notices to Members*. Members are urged to review their systems and procedures to ensure that they are designed to incorporate and reflect the principles contained therein.<sup>3</sup> The purpose of this *Notice* is to reiterate some of those principles, address the obligation to provide best execution generally, and to provide guidance on conducting regular and rigorous reviews.

### The Duty Of Best Execution

Although not specifically defined, a broker/dealer's duty of best execution derives from common law agency principles and fiduciary obligations. These principles have been incorporated in self-regulatory organization (SRO) rules and, through judicial and SEC decisions, in the enforcement of the antifraud provisions of the federal securities laws. Courts have held that the duty of best execution requires that a broker/dealer seek to obtain for its customers' orders the most favorable terms reason-

ably available under the circumstances.<sup>4</sup> The obligation of best execution also is codified in NASD Rule 2320, which provides that in any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for a security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The factors articulated in NASD Rule 2320(a) to be used when applying the of "reasonable diligence" in this area are:

1. the character of the market for the security, *e.g.*, price, volatility, relative liquidity, and pressure on available communications;
2. the size and type of transaction;
3. the number of primary markets checked; and
4. the location and accessibility to the customer's broker/dealer of primary markets and quotation sources.

As illustrated by the language of NASD Rule 2320, the determination as to whether a member exercised reasonable diligence to ascertain the best inter-dealer market for the security and bought or sold in that market so that the resultant price to the customer was as favorable as possible necessarily involves a "facts and circumstances" analysis. Depending upon the particular set of facts and circumstances surrounding an execution, actions that in one instance may meet a firm's best execution obligation may not satisfy that obligation under another set of circumstances.

### **The Evolving Nature Of Best Execution**

Members should be aware that technological developments and changes to market structure are significant factors that must be considered when assessing reasonable diligence and best execution in general. In this regard, the SEC has stated that "the scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices."<sup>5</sup> As these changes in the market occur, broker/dealers must analyze and modify their order execution procedures to consider price opportunities that become "reasonably available."<sup>6</sup> The courts also have recognized a duty on the part of broker/dealers periodically to examine their practices in light of market and technology changes and to modify those practices if necessary to enable their clients to obtain the best reasonably available prices.<sup>7</sup> However, it is clear that the entry or routing of an order to a specific system or market is not a guarantee that a member has obtained best execution for a customer order, nor is the failure to route an order to a specific system or market necessarily a violation of best execution.<sup>8</sup>

### **Executing Small Orders On An Automated Basis At The National Best Bid Or Offer May Not Satisfy A Member's Duty Of Best Execution**

In providing guidance to broker/dealers and the investing public concerning the parameters of the duty of best execution, the SEC and the NASD have recognized the practical necessity of automating the handling of small orders. In the context of aggregate order handling decisions, however, the

importance of the opportunity for customer orders to be executed at prices that are better than the NBBO is a factor in best execution determinations. The SEC has stated that "routing order flow for automated execution, or internally executing order flow on an automated basis, at the best bid or offer quotation, would not necessarily satisfy a broker-dealer's duty of best execution for small orders in listed and OTC securities."<sup>9</sup> The reasoning behind this view is that prices better than the NBBO may be readily accessible to the member.

In fact, the SEC noted specifically that, "[p]rices superior to the public quote may at times be available in [Electronic Communications Networks (ECN(s)), even after adoption of the ECN [Rule], based, for example, on orders of institutional participants and others not covered by the ECN [Rule]. Superior prices also may be available in systems not classified as ECNs.... [W]here reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders."<sup>10</sup> The SEC acknowledged that many of the systems where such superior prices reside are less accessible and involve higher costs for broker/dealers than do the public markets. The SEC further acknowledged that, in many cases, it is not currently feasible to obtain price information efficiently from these systems or to link to these systems on an automated basis. Moreover, the SEC said it was not suggesting that broker/dealers access these systems on a manual basis when handling small orders. The SEC explained, however, that as "technology is rapidly making these systems more accessible, broker/dealers

must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for the purposes of seeking best execution of these customer orders.”<sup>11</sup> For instance, if it becomes cost-effective for a broker/dealer to access an ECN or other market for its retail order flow, then such broker/dealer “must take the prices and other relevant costs in that system into account in handling these customer orders.”<sup>12</sup> These principles also reinforce the discussion above concerning a broker/dealer’s obligation to examine its practices in light of market and technology changes and to modify those practices if necessary to enable its clients to obtain the best reasonably available prices.

### **Regular And Rigorous Review For Best Execution**

As stated above, an important focus of the NASD’s examination program concerns the review of a member’s procedures to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security. The requirement to regularly and rigorously examine execution quality flows from the SEC’s acknowledgment that it may be impracticable for broker/dealers to provide individualized treatment for certain classes of orders. Instead, the SEC permitted broker/dealers to route those orders to a particular market center for handling and execution, so long as the routing broker/dealer periodically assesses the quality of competing markets and directs its order flow based on this assessment. Although the reach of the regular and rigorous requirement has been articulated by the SEC in a variety of ways throughout the

years, it is clear that a broker/dealer may conduct a regular and rigorous review (as opposed to an order-by-order review) for small orders routed or executed pursuant to a predetermined arrangement,<sup>13</sup> including internally executed orders where order-by-order routing is impracticable.<sup>14</sup>

Member firms that route customer orders to other broker/dealers for execution on an automated, non-discretionary basis, as well as firms that internalize customer order flow, must have procedures in place to ensure the firm conducts regular and rigorous reviews of the quality of the executions of its customers’ orders. The SEC has articulated certain factors that broker/dealers should consider when meeting its “regular and rigorous” examination obligations:

Where material price differences exist between the price improvement opportunities offered by markets or market makers, these differences must be taken into account by the broker-dealer. Similarly, in evaluating its procedures for handling limit orders, the broker-dealer must take into account any material differences in execution quality (e.g., the likelihood of execution) among various markets or market centers to which limit orders may be routed. The traditional non-price factors affecting the cost or efficiency of executions should also continue to be considered; however, broker-dealers must not allow an order routing inducement, such as payment for order flow or the opportunity to trade with that order as principal, to interfere with its duty of best execution.<sup>15</sup>

### **Recently Adopted SEC Rules Concerning The Disclosure Of Order Routing And Execution Practices**

The SEC recently adopted two rules concerning the disclosure of order routing and execution practices, Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act.<sup>16</sup> Pursuant to Rule 11Ac1-5 under the Exchange Act, all market centers, defined as “any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association”<sup>17</sup> must make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. To facilitate comparisons across market centers, the rule adopts basic measures of execution quality (effective spread, rate of price improvement and disimprovement, fill rates and speed of execution) and sets forth specific instructions on how the measures are to be calculated. The statistical information will be categorized by individual security, by five types of orders (e.g., market and inside-the-quote limit) and four order sizes (e.g., 100-499 shares and 500-1999 shares). As a result, users of the market center reports will have great flexibility in determining how to summarize and analyze statistical information relevant to the execution of orders. Users of the data will be able to analyze order executions for a particular security or for any particular group of securities, as well as for any size or type of order across those groups of securities. This rule will be phased in by security commencing May 1, 2001.

Under Rule 11Ac1-6 under the Exchange Act, all broker/dealers (including introducing firms) that

route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. Broker/dealers will be required to comply with this rule for all covered securities on July 2, 2001. In addition, broker/dealers will be required to disclose to customers, on request, the venues to which their individual orders were routed for orders routed on July 2, 2001 and thereafter.

### Questions And Answers

#### **1. Why must a firm conduct a regular and rigorous review of execution quality?**

The regular and rigorous examination requirement substitutes for having to analyze certain order routing decisions on an order-by-order basis, when such analysis is impracticable. The SEC previously has recognized the impracticality of such a requirement and instead required that broker/dealers, to satisfy their best execution obligations for routed orders, "periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders."<sup>18</sup>

#### **2. What is a regular and rigorous review of execution quality?**

The focus of the analysis is to determine whether any "material" differences in execution quality exist and, if so, to modify the firm's routing arrangements or justify why it is not modifying its routing arrangements. This analysis must compare the quality of the executions the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to

the quality of the executions that the firm could obtain from competing markets and market centers. Accordingly, a broker/dealer must evaluate whether opportunities exist for obtaining improved executions of customer orders.

#### **3. Which member firms must perform this review? Must introducing firms conduct this type of review?**

The review should be performed by any member that routes customer order flow to another broker/dealer for execution on an automated, non-discretionary basis, as well as firms that internalize customer order flow.

NASD Regulation realizes that many member firms do not execute customer orders on a principal or agency basis,<sup>19</sup> but rather route all customer order flow that they receive to an executing broker/dealer. This executing broker/dealer is, in many instances, the introducing broker/dealer's clearing firm and handles the introducing broker/dealer's customers' securities accounts on a fully disclosed basis. The executing broker/dealer, depending on the particular transaction, may act as principal, riskless principal, or agent with respect to customer orders that it receives from its introducing broker. In other instances, an introducing broker/dealer may route customer order flow to another broker/dealer who pays the introducing broker/dealer for customer order flow.

Despite the fact that an introducing broker/dealer may never execute customer orders, it nonetheless has an obligation to ensure that its customer orders are executed in a manner consistent with the duty of best execution. No NASD member can transfer to another entity its obligation to provide best

execution to its customers' orders. Therefore, an introducing firm has an obligation to conduct an independent review for execution quality. NASD Regulation understands, however, that executing broker/dealers usually are better positioned than introducing broker/dealers to evaluate the quality of executions that an introducing broker/dealer's customers receive, especially where such customer order flow is routed on a routine or automated basis to the executing broker/dealer. Therefore, NASD Regulation believes that an introducing broker/dealer must take reasonable steps to ensure that the introducing broker/dealer and its executing broker/dealer are complying with the duty of best execution. An introducing firm that routes its order flow to its clearing firm or other executing broker/dealer can rely on the clearing or executing firm's regular and rigorous review as long as the statistical results and rationale of the review are fully disclosed to the introducing firm and the introducing firm periodically reviews how the clearing or executing firm is conducting that review, as well as the results of that review. In cases where the introducing broker/dealer is relying on the review conducted by its clearing firm or other executing broker/dealer, the introducing firm must ensure that such analysis is thorough, considers the execution quality of a broad range of market centers, measures the execution quality provided by the clearing or executing firm for the introducing firm's own orders, and considers market centers to which the clearing or executing firm currently routes its order flow as well as market centers other than those to which the clearing or executing firm currently routes its order flow. Subsequent to its review of this information, the introducing firm should exercise its independent judgment

and decide whether to retain its current order routing algorithm or modify it in some manner.

**4. What factors should the member consider in reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets and market centers?**

- A. Material differences in execution quality, including price improvement opportunities. The SEC has defined price improvement as the difference between the execution price and the best quotes prevailing in the market at the time the order arrived at the market or market maker;<sup>20</sup>
- B. Material differences in price disimprovement (situations in which a customer receives a worse price at execution than the best quotes prevailing in the market at the time the order arrived at the market or market maker);
- C. The likelihood of execution of limit orders;
- D. Other material differences in execution quality such as the speed of execution, size of execution, and transaction cost;
- E. Customer needs and expectations; and
- F. The existence of internalization or payment for order flow arrangements (which must not interfere with a firm's best execution obligation.)<sup>21</sup>

**5. Has the SEC provided guidance with respect to the level of specificity that must be applied to the review?**

The SEC has stated that the review must be conducted on a

security-by-security, type-of-order basis (e.g., limit order, market order, and market on open order). "If different markets may be suitable for different types of orders or particular securities, the broker/dealer will also need to consider such factors."<sup>22</sup>

**6. How should procedures to conduct such a review be structured?**

As with any element of a firm's supervisory system, these procedures must be tailored to the particular business mix of the firm and must reasonably be designed to achieve compliance with the applicable securities laws and regulations concerning the duty of best execution. At a minimum, firms must demonstrate procedures that describe who at the firm is responsible for conducting the regular and rigorous review; how the review is going to be conducted; the frequency with which the review will be conducted; and how the review will be evidenced. Some firms have established best execution committees that meet quarterly or more frequently to conduct this review and determine, if necessary, to modify the firm's order routing and execution arrangements. Members should review the guidance that the NASD has provided in previous *NASD Notices to Members* concerning adequate supervisory systems and supervisory procedures.<sup>23</sup>

**7. How often should a regular and rigorous review be conducted?**

Again, this depends on the business mix and level of sales and trading activity being conducted at the firm. At a minimum, firms should conduct such reviews on a quarterly basis; however, members should consider, based on the firm's business, whether more

frequent reviews are needed, particularly in light of the monthly market center statistics made available under Rule 11Ac1-5.

**8. Where can a member firm obtain information about the quality of execution of its customers' orders and the quality of executions received at other market makers or market centers?**

- A. Information Concerning Execution of Firms' Own Orders
  - (i) Some firms have developed internal reports that identify situations where trades are executed outside the NBBO and where price improvement has been obtained.
  - (ii) NASD Regulation issues "Compliance Report Cards" for best execution to member firms. This report card assists members by reflecting the percentage of each firm's transactions where the firm apparently has executed trades under a certain size at a price inferior to the NBBO. This report card sets forth in percentage terms the extent to which a member firm has (or has not) executed transactions at the NBBO and ranks such firms against others member firms that execute a similar number of transactions.
  - (iii) Outside services provide periodic reviews of a firm's executions, including reviews for executions as compared to the NBBO, timeliness of execution, size improvement opportunities and price improvement and disimprovement opportunities.

- (iv) A firm can examine its own report created pursuant to Rule 11Ac1-5 under the Exchange Act.
- B. Sources of Information About Other Markets or Market Centers
- (i) Commencing at the end of June 2001 (covering trading that took place in May 2001), members can use the monthly electronic reports produced pursuant to Rule 11Ac1-5 under the Exchange Act to learn more about the quality of executions of other markets or market centers. These reports will contain uniform statistical measures of execution quality on a security-by-security basis. The uniform statistical measures required by the rule should make a member's review more accurate and easier to accomplish because it will allow the member to compare market centers through the use of statistics generated pursuant to mandated formulae. This rule will require basic measures of execution quality such as, among other things, effective spread, rate of price improvement and disimprovement, fill rates and speed of execution. As the SEC stated, "[a]lthough these statistics are by no means determinative of best execution, the Commission expects that the monthly reporting of the uniform statistical measures required by the Rule will provide broker-dealers with a clearer sense of execution quality among market centers, and will be helpful to broker-dealers in seeking to fulfill their duty of best execution."<sup>24</sup> A member firm should include the use of these reports in its regular and rigorous review of execution quality, but more information regarding the firm's orders will, in all likelihood, be needed to satisfy its regular and rigorous review obligations.
- (ii) Some firms distribute information about their order handling procedures and the quality of the executions they provide to firms that send them order flow.
- (iii) An introducing firm should request from its executing broker/dealer a copy of any analysis that the executing broker/dealer has done (either on its own or by a third-party vendor) to evaluate the execution quality of customer orders that the introducing broker/dealer routed to the executing broker/dealer for execution. In addition (or alternatively), the introducing broker/dealer can conduct its own evaluation of the quality of execution that its customers' orders have received from its executing broker/dealer.
- (iv) An introducing firm also may request from its executing broker/dealer a copy of the "Compliance Report Card" for best execution that NASD Regulation has made available to it.
- (v) Firms can send questionnaires to market makers or market centers about their order handling procedures and quality of executions.
- (a) Should firms send questionnaires to every market maker or market centers?
- At a minimum, a firm should send such questionnaires to a cross section of market makers and market centers, and document the market makers and market centers to which questionnaires are sent. It is not reasonable to require that questionnaires be sent to every market maker or market center.
- (b) What if a market maker or market center does not respond to the questionnaire?
- Firms can only conduct the review with information that they receive. If a market maker or market center fails to return the questionnaire, that is a factor that should be taken into consideration in determining whether or not to route order flow to that firm. However, the failure to return a questionnaire should not, by itself, be a reason for altering order routing decisions.
- (vi) Firms that elect to use questionnaires should evaluate their business mix in developing them. The type of information a firm should consider requesting in a questionnaire includes, but is not limited to, the following:
- (a) How does the market maker or market center monitor for compliance with its best

execution obligations and the quality of its executions?

- (b) What are the market maker or market center's order execution algorithms?
- (c) How does the market maker or market center operate its order execution facilities in turbulent market conditions?<sup>25</sup>
- (d) What are the market maker or market center's automatic execution procedures?
- (e) How does the market maker or market center execute orders at opening and close?
- (f) How and when does the market maker or market center display and protect limit orders?
- (g) Does the market maker or market center use ECNs? Which ones?
- (h) How does the market maker or market center define price improvement?
- (i) What are the firm's recent statistics on price improvement, speed of execution, price disimprovement, cost of trades and size improvement?
- (j) Has the firm been subject to any recent disciplinary actions?

**9. Must a member firm only perform a regular and rigorous review on orders**

**for which it receives payment for order flow?**

This obligation to perform a regular and rigorous review applies to all broker/dealers that route orders for execution regardless of whether they receive payment for directing that order flow. If a broker/dealer, however, receives an order routing inducement, such as payment for order flow, or trades as principal with customer orders, it must not let that inducement interfere with its duty of best execution nor may that inducement be taken into account in analyzing market quality.

**10. Must the firm's regular and rigorous review compare the execution quality provided by different market centers in the execution of options orders?**

Yes. Members executing customers' orders in options classes traded on more than one exchange must conduct a regular and rigorous review for execution quality. As the SEC has stated, "[w]hen an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is simpler than when they must consider the relative merits of routing an order to two or more market centers. With as many as five options exchanges trading certain options classes, brokers are required to regularly and rigorously evaluate the execution quality available at each options exchange."<sup>26</sup>

**11. Is a broker/dealer required to route Nasdaq® market-on-open orders to a market maker or market center that provides mid-point pricing or some other form of price improvement to the**

**execution of market-opening orders?**

While there is no express requirement that broker/dealers route their customers' market-opening orders to such market centers, a member firm, in conducting its regular and rigorous review, should take into account these alternative methods in determining how to obtain best execution for those customer orders.<sup>27</sup> The SEC has emphasized that broker/dealers are subject to a best execution duty in executing customer orders at the opening.

Additionally, each member firm should communicate clearly to customers the choices available for execution of opening orders, as well as the broker/dealer's policy for obtaining best execution of such orders.<sup>28</sup>

This *NASD Notice to Members* is designed to assist the membership in complying with its best execution obligations and should be read in conjunction with previous *NASD Notices to Members*, including *NASD Notices to Members 00-42* (June 2000), 99-12 (February 1999), 99-11 (February 1999), 98-96 (December 1998), 97-57 (September 1997), and 96-65 (October 1996).

Members also should be advised that, during the course of examinations or where appropriate, NASD Regulation staff will request and review the firm's written supervisory procedures concerning the firm's obligation to conduct a regular and rigorous review of the quality of the executions it provides to its customers. In this connection, examiners will request and review the documentation evidencing that such review has been conducted. Members also should be advised that the SEC is actively examining this area.

### Endnotes

- 1 See *infra* notes 13 and 14 accompanying text.
- 2 The SEC's Office of Compliance Inspections and Examinations recently stated that it found, after conducting a review of the compliance by broker/dealers with the duty of best execution, that "many broker-dealers were not meeting their best execution obligations because they sent all of their order flow to their clearing firm and conducted no independent review of execution quality, they limited their review to those markets to which they currently routed order flow, or otherwise appeared not to conduct a thorough analysis of execution quality likely to be obtained from various markets." *Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*, at 8 (January 25, 2001).
- 3 See *NASD Notices to Members 00-42* (June 2000), *99-12* (February 1999), *99-11* (February 1999), *98-96* (December 1998), *97-57* (September 1997), and *96-65* (October 1996).
- 4 See, e.g., *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 135 F.3d 266, 270 (3d Cir. 1998) (en banc) (citation omitted), cert. denied sub nom. *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Kravitz*, 525 U.S. 811 (1998).
- 5 Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48322-48323 (September 12, 1996) (hereinafter cited as "SEC Order Handling Release"). This Release is copied in its entirety as published in the Federal Register in the Appendix to *NASD Notice to Members 96-65* (October 1996). For the convenience of the reader, this *Notice* also will cite to *NASD Notice to Members 96-65* when referencing this particular SEC Release. *NASD Notice to Members 96-65* at 540-541.
- 6 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote and quotation omitted).
- 7 *Newton*, 135 F.3d at 271.
- 8 For example, NASD Regulation and Nasdaq have stressed that the use of the Primex Auction System™, or any other system operated by Nasdaq or other market centers, does not assure best execution in and of itself. Broker/dealers must exercise similar diligence in evaluating these systems as in making other order routing decisions. See *NASD Notice to Members 00-65* at 478 (September 2000) ("Nasdaq will offer the Primex facility to any NASD member that chooses to use this type of system to obtain price improvement or enhanced liquidity for its customer or principal orders. The facility is meant to serve as a means, but certainly not as the exclusive acceptable means, for obtaining price improvement. No NASD rule will require an NASD member to use Primex in meeting a member's best execution obligations.").
- 9 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).
- 10 *Id.* (citation omitted). The ECN Rule, Rule 11Ac1-1(c)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), requires market makers to publicly display limit orders that they place into ECNs that are priced better than their public quote, unless the ECN satisfies certain enumerated conditions. SEC Order Handling Release at 48331, *NASD Notice to Members 96-65* at 549. While the adoption and implementation of Regulation ATS by the SEC has certainly reduced the number of instances in which better-priced orders are resident in ECNs but not publicly disseminated, even with Regulation ATS, there are instances where this can still occur (i.e., where an ECN accounts for less than five percent of the reported volume in a security).
- 11 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541.
- 12 *Id.*
- 13 While the SEC has noted on several occasions that regular and rigorous reviews should be conducted for "retail" or "small" sized orders routed on a collective basis, the SEC has not defined what constitutes a "retail" or "small" sized order or stated explicitly that regular and rigorous reviews should be limited to "retail" or "small" orders. Nevertheless, given that the execution of larger sized orders often requires more judgment in terms of market timing and capital commitment, NASD Regulation believes that routing or internally executing larger sized orders but subjecting them only to a regular and rigorous review (as opposed to an order-by-order review) may raise best execution concerns.
- 14 See, e.g., Securities Exchange Act Release No. 15671 (March 22, 1979) ("The Commission continues to believe that a broker routing retail orders in a particular security to a single market (whether by automated or other means) must at least make periodic assessments of the quality of competing markets to assure that it is taking all reasonable steps under the circumstances to seek out best execution of customers' orders."); Securities Exchange Act Release No. 16590 (February 19, 1980) ("[T]he Commission has also indicated that it expects that those broker-dealers that automatically route retail customer orders in a particular security to a predesignated market, at a minimum, make periodic assessments as to the quality of such market....Furthermore, the Commission believes that broker-dealers who choose to automatically route their customer orders to a designated market should be alert for unusual market conditions in the designated market which would require brokers to take additional measures (such as disclosure of market conditions or special handling of customer orders). Examples of such unusual market conditions would include substantial price disparity between [sic] the designated market and other markets, extreme volatility of the market in the security and unusual trading patterns. In addition, the Commission notes that a broker's fiduciary responsibility to obtain best execution of a customer's order under the circumstances may continue beyond the initial routing decision."); Securities Exchange Act Release No. 17583 (February 27, 1981) (quoting Securities Exchange Act Release No. 15671 (March 22, 1979)); Securities Exchange Act Release No. 26870 (May 26, 1989) (quoting Securities Exchange Act Release No. 16590 (February 19, 1980)); *Market 2000: An Examination of Current Equity Market Developments*, at V-4 (January 1994) ("Currently, most small order flow



routing decisions are predetermined.... The Division believes that an automated routing environment can be consistent with the achievement of best execution. Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order." (footnote omitted); Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (November 2, 1994) ("The Commission traditionally has concluded that a broker-dealer routing customer orders for automated execution could satisfy its best execution obligations so long as the broker-dealer assesses periodically the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for its customers' orders." (footnote omitted); Securities Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322, 15327-15328 (April 5, 1996) ("[B]roker-dealers choosing where to automatically route orders must assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for their customers' orders." (footnote omitted); and SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 ("In the past, the Commission has recognized the practical necessity of automating the handling of small orders. ...At the same time, the Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.... The Commission believes that broker-dealers deciding where to route or execute small customer orders in listed or OTC securities must carefully evaluate the extent to which this order flow would be afforded better terms if executed in a market or with a market maker offering price improvement opportunities." (footnotes omitted).

15 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnotes omitted).

16 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414 (December 1, 2000); See *NASD Notice to Members 01-16* (February 2001).

17 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75437 (December 1, 2000).

18 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).

19 Such broker/dealers usually are precluded by the NASD or their clearing firm, or both, from executing transactions, and are only permitted to act as introducing brokers with respect to customer order flow. In fact, some clearing firms will provide clearing services only if the introducing firm routes all of its orders to the clearing firm. NASD Regulation also acknowledges that other broker/dealers, while not precluded by the NASD or its clearing firm from executing customer orders, choose not to execute such orders for business reasons.

20 SEC Order Handling Release at 48323 fn.357, *NASD Notice to Members 96-65* at 541 fn.357.

21 In this regard, the SEC stated that, "in light of a broker-dealer's obligation to assess the quality of the markets to which it routes packaged order flow absent specific instructions from customers, the Commission does not believe that a broker-dealer violates its best execution obligation merely because it receives payment for order flow or trades as principal with customer orders." SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541 (footnote omitted).

22 SEC Order Handling Release at 48323, *NASD Notice to Members 96-65* at 541.

23 See *NASD Notices to Members 99-45* (June 1999) and 98-96 (December 1998).

24 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75432 (December 1, 2000).

25 See *NASD Notice to Members 99-12* (February 1999).

26 Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439, 75439-75440 (December 1, 2000).

27 Disclosure or Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000).

28 Id.

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