Notice to Members

OCTOBER 2005

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Senior Management
Systems
Trading

KEY TOPICS

IM-2110-2
Limit Orders
Manning Rule

GUIDANCE

Manning Obligations

SEC Approves Amendments to IM-2110-2 to Require Members to Provide Price Improvement to Customer Limit Orders in Certain Circumstances and to Expand IM-2110-2 to Exchange-Listed Securities; **Effective Date: January 2, 2006**

Executive Summary

On August 4, 2005, the Securities and Exchange Commission (SEC) approved amendments to Interpretive Material (IM)-2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule"), to require members to provide price improvement to customer limit orders in certain circumstances and expand the application of IM-2110-2 to exchange-listed securities.[1] IM-2110-2, as amended, is set forth in Attachment A of this *Notice.* The amendments become effective on January 2, 2006.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126, or the Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071.

Background and Discussion

IM-2110-2 generally prohibits a member from trading for its own account at prices that would satisfy a customer's limit order, unless the member immediately thereafter executes the customer limit order.[2] The legal underpinnings for IM-2110-2 are a member's basic fiduciary obligations and the requirement that it must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."[3]

On August 4, 2005, the SEC approved amendments to IM-2110-2 that require members to provide price improvement to customer limit orders in certain circumstances. Specifically, the amendments require a member that has traded for its own account ahead of a customer limit order that is protected under IM-2110-2 to pass along any price improvement that the member received in the execution of its order. In other words, if the member trades ahead of a customer limit order and receives a better price than the unexecuted customer limit order price, the member must fill the customer limit order at the price at which it traded for its own account or better. For example, if a member buys 100 shares of a security at $10 per share when holding a customer limit order in the same security to buy 100 shares at $10.01 per share, the member is required to fill the customer limit order at $10 per share.

In addition, the amendments expand the application of IM-2110-2 to exchange-listed securities. Rule 6440(f)(2), which generally prohibits members from trading ahead of limit orders in exchange-listed securities, is substantially similar, but not identical to IM-2110-2. To ensure consistency in the application of limit order protection to NASDAQ and exchange-listed securities, the amendments apply IM-2110-2 to exchange-listed securities.[4]

In recognition that the amendments may alter the way that many members handle customer orders, NASD is providing 90 days from this *Notice* for implementation to provide members with adequate time to develop and implement systems to comply with the amendments. As such, the new amendments become effective January 2, 2006.

Endnotes

1 *See* Securities Exchange Act Release No. 52210 (August 4, 2005), 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089).

2 For example, if a member buys 100 shares of a security at $10 per share when holding customer limit orders in the same security to buy at $10 per share equaling, in aggregate, 1,000 shares, the member is required to fill 100 shares of the customer limit orders.

3 *See* NASD Rule 2110. *See also* NASD Rule 2320(a).

4 NASD intends to file a proposed rule change deleting Rule 6440(f)(2), in light of the application of IM-2110-2 to exchange-listed securities.

ATTACHMENT A

Proposed new language is underlined; proposed deletions are in brackets.

IM-2110-2. Trading Ahead of Customer Limit Order

(a) General Applications

To continue to ensure investor protection and enhance market quality, NASD's [the Association's] Board of Governors is issuing an interpretation to NASD [the] Rules [of the Association] dealing with member firms' treatment of their customer limit orders in Nasdaq and exchange-listed securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not "trade ahead" of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. [Such orders shall be protected from executions at prices that are superior but not equal to that of the limit order.] In the interests of investor protection, NASD [the Association] is eliminating the so-called disclosure "safe harbor" previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm.[1]

Rule 2110 [of the Association Rules] states that:

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Rule 2320, the Best Execution Rule, states 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 the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

Interpretation

The following interpretation of Rule 2110 has been approved by the Board:

A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq <u>or exchange-listed</u> security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that[, until September 1, 1995, customer limit orders in excess of 1,000 shares received from another member firm shall be protected from the market maker's executions at prices that are superior but not equal to that of the limit order, and provided further, that] a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than $100,000 in value. <u>In the event that a member acting as market maker trades ahead of an unexecuted customer limit order at a price that is better than the unexecuted limit order, such member is required to execute the limit order at the price received by the member or better.</u> Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, <u>NASD</u> [the Association] wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. <u>NASD</u> [The Association] believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm's market-making capacity does not occur. [For purposes of this interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer's limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market-making unit may not trade ahead of that customer's limit order.]

As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis when holding an unexecuted limit order for a Nasdaq security trading in fractions, and not be required to execute the held limit order, is as follows:

- If actual spread is greater than 1/16 of a point, a firm must price improve an incoming order by at least a 1/16. For stocks priced under $10[,] (which are quoted in 1/32 increments), the firm must price improve by at least 1/64.

- If actual spread is the minimum quotation increment, a firm must price improve an incoming order by one-half the minimum quotation increment.

For Nasdaq securities authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, and not be required to execute the held limit order, is as follows:

1) For customer limit orders priced at or inside the best inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

2) For customer limit orders priced outside the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming order at a price at least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01).

NASD [The Association] also wishes to emphasize that all members accepting customer limit orders owe those customers duties of "best execution" regardless of whether the orders are executed through the member's market-making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. NASD[The Association] emphasizes that order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

(b) and (c) No change.

1 For purposes of [the pilot program expanding]the operation of certain Nasdaq transaction and quotation reporting systems and facilities [in SR-NASD-99-57]during the period from 4 p.m. to 6:30 p.m. Eastern Time, members may generally limit the life of a customer limit order to the period of 9:30 a.m. to 4 p.m. Eastern Time. If a customer does not formally assent ("opt-in") to processing of [their]the customer's limit order(s) during the extended hours period commencing after the normal close of the Nasdaq market, limit order protection will not apply to that customer's order(s).