Notice to Members

JANUARY 2006

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Senior Management
Systems
Trading

KEY TOPICS

IM-2110-2
Manning Rule
Market Orders
Rule 2111

GUIDANCE

Market Order Protection

NASD Provides Guidance Regarding New Rule 2111 Prohibiting Members from Trading Ahead of Customer Market Orders Under Certain Circumstances; **Effective Date: January 9, 2006**

Executive Summary

In October 2005, NASD issued *Notice to Members (NTM) 05-69* informing members of Securities and Exchange Commission (SEC) approval of new Rule 2111, Trading Ahead of Customer Market Orders. Among other things, new Rule 2111 prohibits a firm that accepts and holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order. Rule 2111 becomes effective on January 9, 2006. In this *Notice*, NASD staff is providing questions and answers regarding the application of the new rule to assist member firms in their implementation. NASD filed this *Notice* with the SEC as a proposed rule change on January 6, 2006.[1] The proposed rule change became effective upon filing pursuant to Section 19(b)(3)(A)(i) of the Securities Exchange Act and Rule 19b-4(f)(1) thereunder, in that the proposed rule change constitutes a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of an existing NASD rule. The compliance date of the proposed rule change will be January 9, 2006, which coincides with the compliance date for Rule 2111.

Questions/Further Information

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

Background

As further described in *NTM 05-69*, the SEC approved new Rule 2111, which prohibits a firm that accepts and holds a customer market order from trading for its own account on the same side of the market as the customer market order at prices that would satisfy the customer's market order, unless the firm immediately thereafter executes the customer market order up to the size and at the same price or better at which the firm traded for its own account.[2]

In addition, if a member is holding a customer market order that has not been immediately executed, Rule 2111 requires that the member make every effort to match the pending market order against any market orders, marketable limit orders or non-marketable limit orders priced better than the best bid or offer, received by the member on the other side of the market. Such orders must be executed at a price that is no less than the best bid, no greater than the best offer at the time the subsequent order is received by the member, and consistent with the terms of the pending market order. In the event that a member is holding multiple orders on both sides of the market that have not been executed, the member must make every effort to cross or otherwise execute such orders in a manner that is reasonable and is consistent with the objectives of the rule and with the terms of the orders. Members must have a written methodology in place governing the execution priority of all such pending orders, whether the member is holding one order or multiple orders on both sides of the market, and must ensure that such methodology is consistently applied. The new rule becomes effective on January 9, 2006.

Questions and Answers Relating to Market Order Protection

To help members implement Rule 2111, NASD is publishing the following questions and answers relating to the application of new Rule 2111.

Q1 To which securities does Rule 2111 apply?

A Rule 2111 applies to all NASDAQ and exchange-listed securities.

Q2 Does Rule 2111 apply to non-market makers?

A Yes. Rule 2111 applies to all firms that accept and hold customer market orders, irrespective of whether the firm is a market maker in the security.

Q3 Does Rule 2111 apply to orders accepted by a firm on a "not held" basis?

A An order for which a customer has granted the firm discretion with respect to time or price would not be considered a "market" order for the purposes of Rule 2111 and therefore would not be subject to the requirements of Rule 2111. However, this in no way changes a firm's best execution obligations with respect to the order under Rule 2320.

Q4 Do the requirements under paragraphs (b) and (c) of Rule 2111 apply to odd-lot orders?

A No. In other words, odd-lot orders are not subject to the requirements under Rule 2111 (b) and (c); nor does the receipt of such orders on the other side of the market of a protected market order trigger the firm's requirement to cross orders under Rule 2111(c). However, Rule 2111 does apply to mixed-lot orders (*e.g.*, 150 shares) in both cases. In addition, firms are required to make every effort to execute odd-lot orders fully and promptly as required by Rule 2111(a) and must comply with Rule 2320(a) with respect to those orders.

Q5 Does Rule 2111 apply to customer market orders received from other broker-dealers?

A Yes. Similar to IM-2110-2, protected customer market orders include orders received from the firm's own customers as well as customer orders of another broker-dealer.

Q6 For purposes of Rule 2111, what does "accepts and holds" a customer market order mean?

A A firm that has accepted a customer market order and does not immediately execute the order or immediately route the order to a market center for which the firm has a reasonable expectation that the order will be executed consistent with Rule 2320 will be deemed to have "accepted and held" the order for purposes of Rule 2111.

Q7 Once my firm has immediately routed a market order to another market center, does it still have any obligations under Rule 2111?

A Yes. Although a firm will not be deemed to have "accepted and held" a market order if the firm immediately routes the order to a market center for which the firm has a reasonable expectation that the order will be executed consistent with Rule 2320, the firm has a continuing obligation under Rule 2111 to monitor whether the order is, in fact, executed in accordance with Rule 2320 and the specific terms of the order. In this regard, it may be necessary for the firm to retract its order from the recipient market center to comply with Rule 2111 if it appears that the market center will not provide the order best execution.

Under these circumstances, once the firm has retracted the order, the firm is obligated to comply with the provisions of Rule 2111 with respect to the order if the firm accepts and holds the order at that time. However, in all cases, if the firm traded for its own account on the same side of the market as the routed customer order while the customer order was pending at another market center, the firm must immediately fill the customer order at the best price(s) and up to the size it traded for its own account while the order was pending.

Q8 Does Rule 2111 apply to institutional-sized market orders or market orders placed by large institutions?

A Yes. However, as orders for institutions and institutional-sized orders generally involve best-effort commitments and substantial capital commitments by the firm, firms handling such orders can negotiate specific terms and conditions to permit the firm to trade along side of, or ahead of, the institution or an institutional-sized order without violating Rule 2111. Such terms and conditions are permissible only if the market order is placed on behalf of an institutional account, as defined in Rule 3110(c)(4), or is greater than 10,000 shares (and the value of that order is $100,000 or greater), and the customer agrees to the terms and conditions.

Q9 How should the firm disclose such terms and conditions, as described in Question 8, to customers?

A As noted above, Rule 2111 allows firms to negotiate specific terms and conditions that would permit the firm to trade along side of, or ahead of, the market order only with respect to institutional accounts or market orders that are 10,000 shares or more and the value of that order is $100,000 or more. The firm imposing the terms and conditions on the market order must ensure that those terms and conditions are clearly disclosed and explained to the customer. The appropriate method of disclosure will depend on the customer's level of sophistication and understanding. For example, generalized, arms-length disclosure and acceptance procedures may be sufficient where the customer is sophisticated and clearly understands the disclosures being provided. A firm relying on this exclusion to Rule 2111 must document such disclosures and be able to demonstrate that it has met the conditions of the exclusion.

Q10 Does Rule 2111 mandate any particular methodology for market order handling priority procedures?

A NASD has not mandated any particular order handling procedures and execution priorities among market orders. Thus, a firm may choose any reasonable methodology for the way in which it executes multiple orders that it receives, but the firm must ensure that such methodology is applied consistently and complies with applicable rules and regulations. Such methodology must address the order handling and execution priority of all of the firm's orders, including, but not limited to, market orders, marketable limit orders and limit orders, as well as order handling procedures and execution priorities for orders that have been retracted as described in Question 7.

For example, a firm could use a first in first out (FIFO) methodology or some other objective methodology or formula. It would be inappropriate, however, for a firm's methodology to give priority, for example, to orders of certain "preferred accounts" or to give preference to institutional orders over retail orders.

To the extent a firm elects a specific methodology, the firm must document that methodology and have written supervisory procedures and systems in place to ensure that the methodology it has chosen is consistent with, among other things, the duty of best execution. Further, simply because a firm employs a methodology for order execution and that methodology is followed in a particular circumstance does not automatically mean that any or all customer orders executed pursuant to such a methodology have received best execution under Rule 2320.

Q11 Does Rule 2111 apply to orders for accounts where the firm is bound by another regulation limiting or prohibiting principal transactions with customer orders?

A Consistent with prior interpretations concerning the application of IM-2110-2,[3] the obligation to execute a protected customer market order following a proprietary transaction on the same side of the market would not apply where the order is for an account for which the firm is limited or prohibited from executing a principal transaction with the customer order and the order subject to these restrictions has been sent to another broker-dealer for execution.

Q12 Assume the inside market for security ABCD is 10 to 10.05 and Firm A accepts and holds a market order to buy 1,000 shares of ABCD from Customer C1. If Firm A buys 1,000 shares of ABCD at 10 from Firm B (or from any other source), what obligations would Firm A have under Rule 2111?

A Firm A would be required to fill C1's order at 10 or better. Similarly, if Firm A bought shares for its own account below the best bid of 10, it would be required to fill C1's order at that same price below the bid or better.

Q13 Assume that the inside market for security ABCD is 10 to 10.05 and Firm A accepts and holds a market order to buy 1,000 shares of ABCD from Customer C1 and immediately thereafter, receives a market order to buy 500 shares of ABCD from Customer C2. If Firm A purchases 1,000 shares at 10 to fill C1's order on a riskless principal basis and otherwise meets the requirements of the riskless principal exception to Rule 2111, what are Firm A's obligation to C2?

A Firm A's riskless principal trade would not trigger an obligation by Firm A to execute C2's order under Rule 2111. Similarly, if Firm A were to execute C2's order for 500 shares on a riskless principal basis prior to executing C1's order, the riskless principal trade would not trigger an obligation by Firm A to execute (or partially execute) C1's order.

Q14 Assume the inside market for security ABCD is 10 to 10.05 and Firm A accepts and holds a market order to buy 1,000 shares of ABCD from Customer C1. Subsequent to the receipt of this order, Firm A receives a not held order from an institutional Customer C2 to sell 1,000 shares of ABCD on a net basis for a negotiated fee of .02 per share. If Firm A sells 1,000 shares of ABCD to the street at 10.02 and then buys and reports 1,000 shares of ABCD from Customer C2 at the net price of 10, at what price must the firm sell to Customer C1 to fill C1's pending market order to buy and still be in compliance with Rule 2111?

A Rule 2111 requires that Firm A execute Customer C1's order at a price of 10, the same price at which it traded for its own account, or better.

Q15 May a trading desk other than the market-making desk of the firm trade ahead of or along side a market order held by the market-making desk?

A As described in *NTM 95-43* (June 1995) and *NTM 03-74* (November 2003) relating to the application of IM-2110-2, if the firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-making desks engaged exclusively in proprietary trading from obtaining any knowledge of customer orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices that would satisfy the customer market orders held at the market-making desk. As specifically noted in *NTM 03-74*, NASD will continue to examine and review firms' information barriers for compliance with this and other applicable information barrier standards to, among other things, ensure that there are proper information barriers in place to ensure that other desks are not able to access or benefit in any way from the information regarding trading by customer accounts at other desks.

Q16 If a firm accepts and holds a customer market order, but has not bought or sold securities for its own account on the same side of the market as the customer order and has not received a market order or marketable limit order on the other side of the market, what obligations does the firm have under Rule 2111?

A Rule 2111 and Rule 2320 require the firm to execute that customer market order fully and promptly. Under these facts and circumstances, Rule 2111 would not impose any additional specific obligations on the firm beyond the firm's current obligations to market orders. However, it is important to note that, to the extent a firm does not execute a market order fully and promptly, compliance with Rule 2111 would not safeguard the firm from potential liability due to non-compliance with its best execution responsibilities.

Q17 Assume that the inside market for security ABCD is 10 to 10.05 and Firm A accepts and holds a market order to buy 1,000 shares of ABCD from Customer C1 and immediately thereafter receives a market order to sell 1,000 shares of ABCD from Customer C2. Can Firm A price improve the execution of Customer C2's market order and not be required to execute C1's order?

A No. Rule 2111 requires that Firm A make every effort to cross C1's order at a price that is no less than the best bid (10) and no greater than the best offer (10.05) at the time that C2's market order to sell is received by Firm A. Unlike IM-2110-2, there is no ability to price improve an incoming order to avoid a Rule 2111 obligation to an unexecuted market order.

Q18 Once a firm trades through a customer market order, how quickly must it execute the market order to comply with Rule 2111?

A If a firm trades through a customer market order that it has accepted, the Rule provides that it must immediately execute such market order. To meet this obligation, a firm must execute the market order as quickly as possible. For further guidance, see *NTM 95-67* (Question and Answer No. 5) (August 1995) and *NTM 98-78* (September 1998).

Q19 Does the guidance provided by NASD in *NTM 98-78* (September 1998) concerning the application of IM-2110-2 during unusual market conditions apply to Rule 2111?

A Yes. As described in more detail in *NTM 98-78*, under appropriate circumstances, orders need not be filled within one minute if activated during unusual market conditions and if all reasonable steps are taken to execute the transaction as soon as possible following activation.[4]

Endnotes

1 *See* File No. SR-NASD-2006-003. *See also* 15 U.S.C. 78s(b)(3)(A)(i) and 17 CFR 240.19b-4(f)(1).

2 *See* Securities Exchange Act Release No. 52226 (August 9, 2005), 70 FR 48219 (August 16, 2005) (File No. SR-NASD-2004-045).

3 *See* Letters from The Nasdaq Stock Market, Inc., dated July 3, 1997, re: Exemption from Limit Order Protection Rule for Registered Investment Advisers Maintaining a Wrap Fee Account Programs, and dated April 16, 1997, re: Exemption from Limit Order Protection involving ERISA.

4 *See* NASD *NTM 98-78* (September 1998).