Notice to Members

APRIL 2007

SUGGESTED ROUTING

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KEY TOPICS

IM-2110-2
Limit Orders
Limit Order Protection
Manning Rule
Rule 6541

GUIDANCE

Trading Ahead of Customer Limit Orders

SEC Approves Amendments to Expand IM-2110-2 to Include OTC Equity Securities; **Effective Date: July 26, 2007**

Executive Summary

On February 26, 2007, the Securities and Exchange Commission (SEC) approved amendments to Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order, to apply to over-the-counter (OTC) equity securities.[1] The amendments also modify the minimum price-improvement standards set forth in IM-2110-2 with respect to both NMS stocks and OTC equity securities. IM-2110-2, as amended, is set forth in Attachment A of this *Notice*. The amendments become effective on July 26, 2007.

Questions/Further Information

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

Background and Discussion

IM-2110-2 generally prohibits a member from trading for its own account in an NMS stock[2] at a price that is equal to or better than an unexecuted customer limit order in that security, unless the member immediately thereafter executes the customer limit order at the price at which it traded for its own account or a better price.[3] 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."[4]

Currently, the requirements in IM-2110-2 apply only to NMS stocks. However, Rule 6541 (Limit Order Protection), which is similar but not identical to IM-2110-2, applies the general principles of IM-2110-2 to a subset of OTC equity securities—those that are quoted on the OTC Bulletin Board (OTCBB). On February 26, 2007, the SEC approved amendments that expand the scope of IM-2110-2 to apply to all OTC equity securities and delete Rule 6541, as those requirements are now subsumed in IM-2110-2.[5]

Members should be aware that the limit order protection requirements under IM-2110-2 differ from those under Rule 6541 in several ways.[6] Upon implementation of the amendments described in this *Notice*, members must comply with the requirements of IM-2110-2 for those limit orders previously covered by Rule 6541.

First, both IM-2110-2 and Rule 6541 provide that a member is not deemed to have traded ahead of a customer limit order if the member provides a contemporaneous execution of the customer's order. Rule 6541 currently provides a maximum time limit of five minutes, within which an execution of a customer order will be deemed contemporaneous with an execution for a member firm's account. IM-2110-2 prescribes a shorter maximum time limit (as soon as possible, but absent reasonable and documented justification, within one minute) within which an execution of a customer order will be deemed contemporaneous with an execution for the firm's account.[7] In addition, Rule 6541 requires that the customer limit order be executed at the limit price, while IM-2110-2 requires that the customer limit order be executed at the price of the firm's execution if better than the limit price. Accordingly, upon implementation of the amendments, members must comply with the IM-2110-2 standard for all securities.

Second, IM-2110-2 contains a higher dollar value threshold for the order size at which firms may negotiate terms and conditions to permit them to continue to trade along side of, or ahead of, the limit order, if the customer agrees. Rule 6541 requires that an order be 10,000 shares or more and greater than $20,000 in value, while IM-2110-2 requires that an order be 10,000 shares or more and greater than $100,000 in value. Upon implementation of the amendments, members must comply with the higher dollar value threshold for all securities.

Third, IM-2110-2 applies from 9:30 a.m. to 6:30 p.m. Eastern Time (ET),[8] whereas Rule 6541 currently applies only during the normal market hours of 9:30 a.m. to 4:00 p.m. ET.

Finally, IM-2110-2 and Rule 6541 contain different standards relating to the minimum level of price improvement that a member must provide to trade ahead of an unexecuted customer limit order.[9] Rule 6541 requires that for customer limit orders priced at or inside the current inside spread, the minimum price improvement must be a minimum of the lesser of $.01 or one-half (1/2) of the current inside spread. IM-2110-2 currently requires a minimum price improvement of a $.01 for limit orders priced at or inside the best inside market. For customer limit orders priced outside the best inside market, IM-2110-2 currently requires minimum price improvement at a price at least equal to the next superior minimum quotation increment, while Rule 6541 does not set a minimum price level (although it does require price improvement in such circumstances).

The amendments revise the price-improvement standards for both NMS stocks and OTC equity securities, making them uniform depending on the price of the customer limit order and whether it is priced inside or outside the best inside market. Specifically, for customer limit orders priced greater than or equal to $1.00 that are at or inside the best inside market, the minimum amount of price improvement required is $0.01. For customer limit orders priced less than $1.00 that are at or inside the best inside market, the minimum amount of price improvement required is the lesser of $0.01 or one-half (1/2) of the current inside spread. For customer limit orders priced outside the best inside market, the member is required to execute the incoming order at a price at or inside the best inside market for the security. Lastly, for customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required is $0.01.

NASD is providing 90 days from publication of this *Notice* for implementation to provide members with adequate time to comply with the amended requirements. As such, the amendments become effective July 26, 2007.

Endnotes

1 *See* Securities Exchange Act Release No. 55351 (February 26, 2007), 72 FR 9810 (March 5, 2007) (order approving SR-NASD-2005-146).

2 IM-2110-2 currently uses the term "exchange-listed security." The amendments to IM-2110-2 replace the term "exchange-listed security" with the term "NMS stock," consistent with the terminology used in Regulation NMS. *See* SEC Rule 600(b)(47) of Regulation NMS.

3 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 $10.01 per share equaling, in aggregate, 1,000 shares, the member is required to fill 100 shares of the customer limit order at $10 per share.

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

5 For purposes of the amendments, OTC equity securities are defined as any non-exchange-listed security and certain exchange-listed securities that do not otherwise qualify for real-time trade reporting. This definition does not include options.

6 For a more expansive discussion of the differences between IM-2110-2 and Rule 6541, members also should review the rule filing, SR-NASD-2005-146. *See* Securities Exchange Act Release No. 55351 (February 26, 2007), 72 FR 9810 (March 5, 2007) (order approving SR-NASD-2005-146).

7 *See Notices to Members 95-67* (August 1995) and *98-78* (September 1998).

8 A member may generally limit the life of a customer limit order to the period of 9:30 a.m. to 4 p.m. ET. If a customer does not formally assent to processing of the customer's limit order(s) during the extended hours period commencing after the normal close of the market, limit order protection will not apply to that customer's order. *See* footnote 1 to IM-2110-2.

9 In connection with the approval of the amendments to IM-2110-2, the price-improvement standards, which previously were operating on a pilot basis, became permanent.

ATTACHMENT A

Below is the text of the rule change. New language is underlined; deletions are in brackets.

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

(a) General Application

To continue to ensure investor protection and enhance market quality, NASD's Board of Governors is issuing an interpretation to NASD Rules dealing with member firms' treatment of their customer limit orders in NMS stocks and OTC equity[exchange-listed] securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members to handle their customer limit orders with all due care so that members do not "trade ahead" of those limit orders. Thus, members 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. In the interests of investor protection, NASD 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] For purposes of this interpretation, (1) "NMS stock" shall have the meaning set forth in SEC Rule 600(b)(47) of Regulation NMS and (2) "OTC equity security" shall have the meaning set forth in Rule 6610(d).

Rule 2110 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 an <u>NMS stock or OTC equity</u>[exchange-listed] security and that continues to trade the subject security for its own 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 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. In the event that a member 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. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, NASD wishes to emphasize that members may not trade ahead of their customer limit orders even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. NASD 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.

[As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a member 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, t]The minimum amount of price improvement necessary in order for a member 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 greater than or equal to $1.00 that are 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 less than $1.00 that are at or inside the best inside market, the minimum amount of price improvement required is the lesser of $0.01 or one-half (1/2) of the current inside spread;

3) For customer limit orders priced outside the best inside market [displayed in Nasdaq], the member must price improve the incoming order by executing the incoming order at a price at or inside the best inside market for the security; and[at least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01)]

4) For customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required is $0.01.

NASD 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 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 emphasizes that order entry firms should continue to monitor routinely the handling of their customers' limit orders regarding the quality of the execution received.

(b) through (c) No change.

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1 For purposes of the operation of certain [Nasdaq] transaction and quotation reporting systems and facilities 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 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).

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6541. [Limit Order Protection]Reserved.

[(a) Members shall be prohibited from "trading ahead" of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling 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 customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.]

[(b) Members may avoid the obligation specified in paragraph (a) through the provision of price improvement. If a customer limit order is priced at or inside the current inside spread, however, the price improvement must be for a minimum of the lesser of $0.01 or one-half (1/2) of the current inside spread. For purposes of this rule, the inside spread shall be defined as the difference between the best reasonably available bid and offer in the subject security.]

[(c) Notwithstanding subparagraph (a) of this rule, a member may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to such orders that are:]

[(1) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or]

[(2) for 10,000 shares or more, and greater than $20,000 in value.]

[(d) Contemporaneous trades]

[A member that trades through a held limit order must execute such limit order contemporaneously, or as soon as practicable, but in no case later than five minutes after the member has traded at a price more favorable than the customer's price.]

[(e) Application]

[(1) This rule shall apply, regardless of whether the subject security is additionally quoted in a separate quotation medium.]

[(2) This rule shall apply from 9:30 a.m. to 4:00 p.m. Eastern Time.]