Regulatory Notice 08-49

Trading Ahead of Customer Limit Orders

FINRA Announces Effective Date for Expansion of NASD IM-2110-2 to OTC Equity Securities and Revised Minimum Price-Improvement Standards in IM-2110-2

Effective Date: November 11, 2008

Executive Summary

Effective November 11, 2008, the requirements in *NASD Interpretive Material* (IM) 2110-2 (Trading Ahead of Customer Limit Order) apply to over-the-counter (OTC) equity securities, as defined in NASD Rule 6610(d).[1] Also effective November 11, 2008, the minimum level of price improvement that firms must provide to trade ahead of an unexecuted customer limit order under IM-2110-2 is based on tiered standards that vary according to the price of the customer limit order.[2] The revised price-improvement standards apply to both OTC equity securities and NMS stocks. The text of IM-2110-2, as amended, is set forth in Attachment A of this *Notice*.

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

Background and Discussion

Current IM-2110-2 generally prohibits a firm from trading for its own account in an exchange-listed security at a price that is equal to or better than an unexecuted customer limit order in that security, unless the firm immediately thereafter executes the customer limit order at the price at which it traded for its own account or a better price. The legal underpinnings for IM-2110-2 are a firm's basic fiduciary obligations under agency law 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]

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Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Operations
- Senior Management
- Systems
- Trading
- Training

Key Topics

- Limit Orders
- Limit Order Protection
- Manning Rule
- Minimum Price-Improvement Standards
- OTC Equity Securities

Referenced Rules & Notices

- NASD IM-2110-2
- NASD Rule 6541
- NASD Rule 6610
- NTM 07-19

Financial Industry Regulatory Authority

Expansion of IM-2110-2 to OTC Equity Securities

As announced in *Notice to Members* 07-19 (April 2007), the SEC approved the expansion of IM-2110-2 to OTC equity securities and the deletion of NASD Rule 6541 (Limit Order Protection).[4] Following publication of *NTM 07-19*, FINRA filed with the SEC a proposed rule change to delay the effective date of the expansion of IM-2110-2 to OTC equity securities to coincide with the effective date of the amendments to the minimum price-improvement standards discussed below.[5]

As described more fully in *NTM 07-19*, the limit order protection requirements under IM-2110-2 differ from those under Rule 6541. Effective November 11, 2008, firms must comply with the requirements of IM-2110-2 for limit orders in all OTC equity securities, including those previously covered by Rule 6541.

Revised Minimum Price-Improvement Standards

IM-2110-2 prescribes a minimum level of price improvement that a firm must provide to trade ahead of an unexecuted customer limit order. In other words, the price-improvement standards in IM-2110-2 impose a minimum amount by which a firm must trade, in addition to the price of the customer buy limit order (or less than the price of a customer sell order), to not trigger the protections under IM-2110-2. For example, if a firm is holding a customer limit order to buy priced at $10.01 and the applicable minimum price-improvement standard is $.01, the firm would be permitted to buy at $10.02 or higher without triggering the requirements of IM-2110-2.

As part of the above-referenced proposed rule change expanding the scope of IM-2110-2 to apply to OTC equity securities, the SEC also approved amendments to the minimum price-improvement standards in IM-2110-2. In response to firms' concerns regarding the application of these standards, FINRA delayed the effective date of the approved amendments and subsequently filed with the SEC a proposed rule change to further amend the minimum price-improvement standards based on tiered standards that vary according to the price of the customer limit order. On September 12, 2008, the SEC approved the proposed amendments to the minimum price-improvement standards.[6]

As amended, IM-2110-2 sets forth the following minimum level of price improvement that a firm must provide to trade ahead of an unexecuted customer limit order:

Security Type	Price of Customer Limit Order	Minimum Price Improvement Required
NMS stocks	≥ $1.00	$0.01
OTC equity securities	≥ $1.00	The lesser of $0.01 or ½ of the current inside spread
NMS stocks and OTC equity securities	< $1.00 but ≥ $.01	The lesser of $0.01 or ½ of the current inside spread
NMS stocks and OTC equity securities	< $.01 but ≥ $0.001	The lesser of $0.001 or ½ of the current inside spread
NMS stocks and OTC equity securities	< $.001 but ≥ $0.0001	The lesser of $0.0001 or ½ of the current inside spread
OTC equity securities	< $.0001 but ≥ $0.00001	The lesser of $0.00001 or ½ of the current inside spread
OTC equity securities	< $.00001	The lesser of $0.000001 or ½ of the current inside spread

Additionally, as amended, IM-2110-2 provides that for customer limit orders priced outside the best inside market for the security, the minimum amount of price improvement required must either meet the same tiered minimum price-improvement standards set forth above or the firm must trade at a price at or inside the best inside market for the security. For customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required defaults to the same tiered minimum price improvement standards described above.[7]

Amended IM-2110-2 also requires that any better-priced customer limit orders must receive protection up to the size of the triggering trade. Thus, once the minimum price-improvement standards trigger the protection of a pending customer limit order, a firm would be required to also protect any more aggressively priced customer limit order(s), even if those limit orders would not be directly triggered by the minimum price-improvement standards of IM-2110-2.

For example, assume the best inside market for an NMS stock is $.996 to $1.00 and a firm is holding customer limit orders to sell at prices of $.998 and $1.00. If the firm sells for its own account at $.996, under the minimum price-improvement standards set forth above, customer limit orders to sell priced below $.998 and customer limit orders priced from $1.00 up to, but not including, $1.006 would be protected as a result of the firm's $.996 triggering proprietary trade. Once the limit order priced at $1.00 is activated upon the execution of the firm's trade at $.996 (it is activated because it is within $.01 of the price of the firm's trade), IM-2110-2, as amended, requires that the firm protect any more aggressively priced customer limit orders.

This requirement only applies in the limited circumstance where a firm has a limit order that is protected by IM-2110-2, but more aggressively priced customer limit orders are not protected. Therefore, in this example, if the firm were holding only a customer limit order to sell at $.998 (and not a customer limit order to sell at $1.00), the $.998 order would not be triggered by this requirement.

FINRA is not mandating any particular order handling procedures or execution priorities among protected orders. Firms may choose any reasonable methodology for executing multiple orders triggered by IM-2110-2, but a firm must ensure that such methodology is applied consistently and complies with applicable rules and regulations. In the example above, the firm may implement a methodology that executes all more aggressively priced customer limit orders first (*i.e.,* the limit order priced at $.998) before executing the limit order priced at $1.00.

Firms accepting customer limit orders are reminded that they owe their customers duties of "best execution" regardless of whether the orders are executed through the firm or sent to another firm for execution. Order entry firms should continue to monitor routinely the handling of their customers' limit orders regarding the quality of the execution received.[8]

The expansion of IM-2110-2 to OTC equity securities and the amendments to the minimum price-improvement standards become effective on November 11, 2008.

Endnotes

1 *See* Securities Exchange Act Release No. 55351 (February 26, 2007), 72 FR 9810 (March 5, 2007) (order approving SR-NASD-2005-146). *See also Notice to Members 07-19* (April 2007).

2 *See* Securities Exchange Act Release No. 58532 (September 12, 2008) (order approving SR-NASD-2007-041), available at http://www.sec.gov/rules/sro/nasd/2008/34-58532.pdf.

3 *See* NASD Rule 2110. *See also In re E.F. Hutton & Co.* (known as the "Manning decision"), Securities Exchange Act Release No. 25887, 49 S.E.C. 829 (July 6, 1988), appeal filed, *Hutton & Co. Inc. v. SEC,* Dec. No. 88-1649 (D.C. Cir. September 2, 1988) (Stipulation of Dismissal Filed, January 11, 1989).

4 *See supra,* note 1.

5 *See* Securities Exchange Act Release No. 57133 (January 11, 2008), 73 FR 3500 (January 18, 2008) (notice of filing and immediate effectiveness of SR-FINRA-2007-038). *See also* Securities Exchange Act Release No. 56103 (July 19, 2007), 72 FR 40918 (July 25, 2007) (notice of filing and immediate effectiveness of SR-NASD-2007-39); and Securities Exchange Act Release No. 56822 (November 20, 2007), 72 FR 67326 (November 28, 2007) (notice of filing and immediate effectiveness of SR-FINRA-2007-023).

6 *See supra,* note 2.

7 With respect to OTC equity securities that are foreign securities traded in a foreign currency, firms must convert the foreign currency to US dollars for purposes of determining the applicable minimum price-improvement standards. A firm may use any reasonable business practice for the currency conversion, and must document its practice and apply the methodology consistently.

8 *See* IM-2110-2.

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 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:

* This Attachment A is marked to show the amendments adopted pursuant to SR-NASD-2007-041 relating to the minimum price-improvements standards. The amendments adopted pursuant to SR-NASD-2005-146 relating to the expansion of IM-2110-2 to OTC equity securities appear as existing text.

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 NMS stock or OTC equity 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.

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 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], the minimum amount of price improvement required is $0.01 for NMS stocks and the lesser of $0.01 or one-half (1/2) of the current inside spread for OTC equity securities;

2) For customer limit orders priced greater than or equal to $.01 and 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, 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]

[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.]

For customer limit orders priced less than $.01 but greater than or equal to $0.001, the minimum amount of price improvement required is the lesser of $0.001 or one-half (1/2) of the current inside spread;

4) For customer limit orders priced less than $.001 but greater than or equal to $0.0001, the minimum amount of price improvement required is the lesser of $0.0001 or one-half (1/2) of the current inside spread;

5) For customer limit orders priced less than $.0001 but greater than or equal to $0.00001, the minimum amount of price improvement required is the lesser of $0.00001 or one-half (1/2) of the current inside spread;

6) For customer limit orders priced less than $.00001, the minimum amount of price improvement required is the lesser of $0.000001 or one-half (1/2) of the current inside spread; and

7) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the member must trade at a price at or inside the best inside market for the security.

If the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this IM, even if those better-priced limit orders would not be directly triggered under the minimum price-improvement standards above.

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) and (c) No Change.

1 No change to the footnote.