Regulatory Notice 09-14

Trading Ahead of Customer Limit Orders

SEC Approves Alternative Means for Calculating the Minimum Price-Improvement Obligations Under Certain Circumstances

Effective Date: February 11, 2009

Executive Summary

Effective February 11, 2009, firms are permitted to use an alternative method for calculating the minimum price improvement obligation under NASD IM-2110-2 (Trading Ahead of Limit Orders) in cases where the firm receives a customer limit order in an OTC equity security that is priced below $1.00 and where there is no current published inside spread in that security.

The text of the amendments can be found at *www.finra.org/Industry/Regulation/RuleFilings/2008/P117569*.

Questions regarding this Notice should be directed to Racquel Russell, Assistant General Counsel, Office of General Counsel, at (202) 728-8363.

Background and Discussion

NASD IM-2110-2 provides tiered standards for calculating the minimum level of price improvement that firms must provide to trade ahead of customer limit orders. These tiered standards vary depending on the price of the customer limit order, but as a general matter, they are either a fixed amount or one half of the current inside spread.

March 2009

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Trading and Market Making

Key Topic(s)

- Limit Order Protection
- Minimum Price Improvement

Referenced Rules & Notices

- NASD IM-2110-2

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Prior to the amendments, in cases where there was no current inside spread for a security, the minimum price-improvement standard would default to the fixed amount which, in certain circumstances, was equal to the price of the customer limit order. For example, where a firm received a customer limit order to sell priced at $.01 and there was no current published inside spread, the minimum price-improvement standard would have been equal to $.01, which required the firm to sell for its own account at 0 ($.01 minus $.01) to avoid triggering the customer limit order. Thus, firms were effectively prohibited from selling while the customer limit order was still pending.

To address this unintended consequence, FINRA has amended IM-2110-2 to provide an alternative means of calculating the minimum price improvement obligation in cases where a firm receives a customer limit order in an OTC equity security that is priced below $1.00 and there is no current published inside spread.[1] In such cases, firms may calculate the current inside spread by contacting and obtaining priced quotations from at least two unaffiliated dealers. Once the firm has obtained bid and ask prices from at least two unaffiliated dealers, the firm must use the highest bid and lowest offer as the basis for calculating the current inside spread for determining its minimum price improvement obligation. Additionally, where there is a one-sided quote, the amendments permit a firm to determine the current inside spread by using the best price obtained from at least two unaffiliated dealers on the other side of the quote.

The amendments require that firms document (1) the name of each dealer contacted and (2) the quotations received that were used as the basis for determining the current inside spread. This alternative means of calculating the current inside spread applies solely to minimum price-improvement calculations under IM-2110-2 and would not implicate other rules or requirements (*e.g.*, Three Quote Rule).

Endnotes

1 *See* Securities Exchange Act Release No. 59382 (February 11, 2009), 74 FR 7718 (February 19, 2009) (Order Approving File No. SR-FINRA-2008-064).

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