March 11, 2004

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-2004-045
Proposed Amendments to Require Market Order Protection

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Stephanie M. Dumont, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8176. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2004-045
Consists of 23 Pages
March 11, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to prohibit a member from trading ahead of a customer market order under the circumstances described herein. Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

2111. Trading Ahead of Customer Market Orders

(a) A member must make every effort to execute a customer market order that it receives fully and promptly regardless of the impact on market price. Absent extraordinary circumstances, a member that receives a market order from its own customer or the customer of another broker-dealer in a Nasdaq or exchange-listed security and does not execute the order fully and promptly is prohibited from trading that security for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same or better price at which it traded for its own account.

(b) A member that has not executed a customer market order fully and promptly must cross such order with any market or marketable limit order subsequently received by the member on the other side of the market up to the size of such order at a price equal to the best bid (for purposes of buy orders) or equal to the best offer or (for purposes of sell orders) at the time that the subsequent market or marketable limit order is received by the member. In the event that a member has multiple orders on both sides of the market that have not been executed fully and promptly, the member must have a written methodology in place describing the way in which the member will cross or otherwise execute such orders that is reasonable and is consistent with the objectives of this rule. The member also must ensure that such methodology is consistently applied to all such pending orders.

(c) A member may negotiate specific terms and conditions applicable to the acceptance of a market order only with respect to market 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) 10,000 shares or more, unless such orders are less than $100,000 in value.

(d) This rule also will apply to limit orders that are marketable at the time they are received by the member or become marketable at a later time. Such limit orders shall be treated as market orders for purposes of this rule, however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit order must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable.

(e) The obligations under this rule shall not apply to a member's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the "facilitated order"), provided that all of the following requirements are satisfied:

(1) The handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), 4652(d)(3)(B), 4632A(e)(1)(C) or 6420(d)(3)(B);

(2) A member that relies on this exclusion to the rule must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee;

(3) A member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) and 4632A(e)(1)(C)(ii), or a substantially similar report to another trade reporting system;

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with applicable NASD rules. At a minimum these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner, all orders which a member relies in claiming this exception.

(f) Nothing in this rule changes the application of Rule 2320 with respect to a member's obligations to customer orders.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the NASD Board of Governors at its meeting on March 1, 2004, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 90 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Stephanie M. Dumont, Office of General Counsel, Regulatory Policy and Oversight, NASD at (202) 728-8176.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Interpretive Material 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the “Manning Rule”) generally prohibits members from trading for their own account at prices that would satisfy a customer’s limit order, unless the member immediately thereafter executes the customer limit order.[1] The legal underpinnings for the Manning Rule 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."[2]

NASD believes that the same principles on which the Manning Rule is based should apply to the treatment of customer market orders. As such, NASD is proposing that a member be prohibited from trading for its proprietary account on the same side of the market as a customer market order, if that customer market order has not been executed fully and promptly.

Specifically, the proposed rule change would prohibit a member from trading for its own account in a Nasdaq or exchange-listed security[3] if the member has not executed a customer market order in that security fully and promptly, unless it immediately thereafter executes the customer market order up to the size and at the same or better price at which it traded for its own account.[4] Similar to the application of the Manning Rule, customer market orders would include

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1 For example, if the member bought 100 shares at $10 when holding customer limit orders in the same security to buy at $10 equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders. Rule 6440(f)(2) imposes similar requirements with respect to the receipt of customer limit orders in exchange-listed securities.

2 See NASD Rule 2110.

3 Rule 6440(f)(1) currently prohibits a member from personally buying (selling) an exchange-listed security for its own account while such member holds an unexecuted market order to buy (sell) such security for a customer. The proposed rule change would prohibit a broad range of conduct, including conduct prohibited by Rule 6440(f)(1) and therefore, NASD staff will recommend to Nasdaq that it consider deleting Rule 6440(f)(1), in light of the proposal described herein.

4 The agency obligation of a broker/dealer with respect to a customer order is defined by the customer's expectation of the treatment of the order. A customer's market order generally represents the expectation that the order will be executed fully and promptly at the current best bid, for a sell order, or best offer, for a buy order, regardless of the impact on market price. In attempting to meet this expectation, there is some reasonable period of time in which market orders may queue while the broker/dealer is executing orders ahead on both sides of the market. This proposed rule change represents NASD's view that, when that reasonable time period has expired, the member shall not be permitted to trade that security for its own account on the same side of the market as its customer market order without giving the customer market order an execution at that same price or better.

orders received from the member's own customers or customer orders of another broker/dealer. In addition, if a customer market order has not been executed fully and promptly, a member would be required to match the pending market order against any subsequent market orders or marketable limit orders on the other side of the market received by the member up to the size of the pending market order and at a price that is equal to or better than the best bid for a pending market order to buy or the best offer for a pending market order to sell.

In the event that a member has multiple orders on both sides of the market that have not been executed fully and promptly, the member must have a written methodology in place describing the way in which the member will cross or otherwise execute such orders that is reasonable and is consistent with the objectives of this rule. The member also must ensure that such methodology is consistently applied to all such pending orders.

For example, assume the inside market for security ABCD is 10 to 10.05 and Firm A receives a market order to buy 1,000 shares of ABCD from Customer C1, which Firm A has not executed fully and promptly. If Firm A buys 1,000 shares of ABCD at 10 from Firm B (or from any other source), Firm A would be required to sell 1,000 shares of ABCD to C1 at 10. Similarly, if Firm A bought shares for its own account below the best bid of 10, it would be required to sell stock to C1 at that same price below the bid or better.

Under the same facts described above, if Firm A subsequently receives a market order to sell 1000 shares of ABCD from Customer C2, Firm A would be required to cross the orders from C1 and C2 at the bid of 10.

If a member does not execute an order fully and promptly, but has not bought or sold securities for its own account on the same side of the market as the customer order or has not received a market order from another customer on the contra-side of the market, the proposed rule change would not impose any specific obligations on the member above and beyond the member's current obligations to market orders, such as a member's best execution requirements under Rule 2320.

The proposed rule change also would incorporate several of the same types of exclusions that apply to the Manning Rule. First, the proposed rule change would permit members to negotiate specific terms and conditions applicable to the acceptance of a market order with respect to a market order for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4) or a market order that is for 10,000 shares or more, unless such order is less than $100,000 in value.

Second, the proposal would provide an exception for member proprietary trades that are part of an execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the "facilitated order"). This exclusion would apply only if the following requirements are met: (1) the handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules; (2) the member must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee; (3) a member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) or 4632A(e)(1)(C)(ii), or a substantially similar report; and (4) members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with applicable NASD rules.[5]

For example, assume that the inside market for security ABCD is 10 to 10.05 and Firm A receives 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. Firm A does not execute the orders from C1 and C2 fully and promptly. 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 the proposed rule change, the riskless principal trade would not trigger an execution of C2's order under the proposed rule change. Under the same facts noted above, 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 the execution (or partial execution) of C1's order.[6]

The proposed rule change also applies to limit orders that are marketable at the time they are received by the member or that become marketable at a later time. Such limit orders would be

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5 With respect to requirement (4), the member's policies and procedures, at a minimum, must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner, all orders which a member relies in claiming this exemption.

6 Except as specifically provided in the proposed rule change, NASD has not mandated any particular order handling and execution priority procedures among market orders. Thus, a member may choose any reasonable methodology for the way in which it executes multiple orders that it holds, but the member must ensure that such methodology is applied consistently. For example, a member could use a first in first out (FIFO) methodology or some other objective methodology or formula. It would be inappropriate, however, for a member's methodology to give priority, for example, to orders of certain "preferred accounts" or preference institutional orders over retail orders. To the extent a member elects a specific methodology, the member must document that methodology and have written supervisory procedures and systems in place to ensure that the methodology it has chosen is consistent with the duty of best execution. Further, simply because a member employs a methodology for execution of orders and that methodology is followed in a particular circumstance

treated as market orders for purposes of the proposed rule change, however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit order must be provided the full protections of IM-2110-2 for Nasdaq securities or Rule 6440(f)(2) for exchange-listed securities. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or Rule 6440(f)(2).

The proposed rule change applies to NASD members irrespective of upon which market they trade. If a member were to execute a proprietary trade on an exchange while holding a customer market order on the same side of the market that the member has not fully and promptly executed, then the member would be deemed to have violated the proposed rule change unless (1) the member immediately provides an execution to that market order at a price equal to or better than proprietary trade; or (2) the member's proprietary trade was in accordance with a functional role, recognized within the rules of that exchange, of acting as a liquidity provider, such as acting in the role of a specialist or some other substantially similar capacity.

NASD is emphasizing that nothing in the proposed rule change modifies the application of Rule 2320 with respect to a member's obligations to customer orders. For example, to the extent a member does not execute a market order fully and promptly, compliance with the proposed rule change would not safeguard the member from potential liability due to non-compliance with its best execution responsibilities.

Finally, in recognition that the proposed rule change may alter the way that many members handle customer orders, NASD believes it is important to provide members with adequate time to

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does not automatically mean that any or all customer orders executed pursuant to such a methodology have develop and implement systems to comply with the proposed rule change. Therefore, NASD is proposing an implementation date of 90 days after the issuance of a Notice to Members announcing SEC approval of the proposed rule change.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change will improve the treatment of market orders and enhance the integrity of the market.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

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received best execution under NASD Rule 2320.

7. <u>Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)</u>

   Not applicable.

8. <u>Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission</u>

   Not applicable.

9. <u>Exhibits</u>

   1. Completed notice of proposed rule change for publication in the <u>Federal</u> <u>Register</u>.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY:____________________________________
Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

Date: March 11, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2004-045)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Proposed Amendments to Require Market Order Protection

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , the National Association of Securities Dealers, Inc. ("NASD"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to prohibit members from trading ahead of a customer market orders under the circumstances described herein. Below is the text of the proposed rule change. Proposed new language is in italics.

* * * * *

2111. Trading Ahead of Customer Market Orders

(a) A member must make every effort to execute a customer market order that it receives fully and promptly regardless of the impact on market price. Absent extraordinary circumstances, a member that receives a market order from its own customer or the customer of another broker-

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

<u>dealer in a Nasdaq or exchange-listed security and does not execute the order fully and promptly is prohibited from trading that security for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same or better price at which it traded for its own account.</u>

<u>(b) A member that has not executed a customer market order fully and promptly must cross such order with any market or marketable limit order subsequently received by the member on the other side of the market up to the size of such order at a price equal to the best bid (for purposes of buy orders) or equal to the best offer or (for purposes of sell orders) at the time that the subsequent market or marketable limit order is received by the member. In the event that a member has multiple orders on both sides of the market that have not been executed fully and promptly, the member must have a written methodology in place describing the way in which the member will cross or otherwise execute such orders that is reasonable and is consistent with the objectives of this rule. The member also must ensure that such methodology is consistently applied to all such pending orders.</u>

<u>(c) A member may negotiate specific terms and conditions applicable to the acceptance of a market order only with respect to market 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) 10,000 shares or more, unless such orders are less than $100,000 in value.</u>

<u>(d) This rule also will apply to limit orders that are marketable at the time they are received by the member or become marketable at a later time. Such limit orders shall be treated as market orders for purposes of this rule, however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit</u>

order must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable.

(e) The obligations under this rule shall not apply to a member's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the "facilitated order"), provided that all of the following requirements are satisfied:

(1) The handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), 4652(d)(3)(B), 4632A(e)(1)(C) or 6420(d)(3)(B);

(2) A member that relies on this exclusion to the rule must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee;

(3) A member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) and 4632A(e)(1)(C)(ii), or a substantially similar report to another trade reporting system;

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with applicable NASD rules. At a minimum these policies and procedures must require that the customer order was

received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner, all orders which a member relies in claiming this exception.

(f) Nothing in this rule changes the application of Rule 2320 with respect to a member's obligations to customer orders.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Interpretive Material 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule") generally prohibits members from trading for their own account at prices that would satisfy a customer's limit order, unless the member immediately thereafter executes the customer limit order.[3] The legal underpinnings for the Manning Rule 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]

NASD believes that the same principles on which the Manning Rule is based should apply to the treatment of customer market orders. As such, NASD is proposing that a member be prohibited from trading for its proprietary account on the same side of the market as a customer market order, if that customer market order has not been executed fully and promptly.

Specifically, the proposed rule change would prohibit a member from trading for its own account in a Nasdaq or exchange-listed security[5] if the member has not executed a customer market order in that security fully and promptly, unless it immediately thereafter executes the customer market order up to the size and at the same or better price at which it traded for its own account.[6] Similar to the application of the Manning Rule, customer market orders would include

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[3] For example, if the member bought 100 shares at $10 when holding customer limit orders in the same security to buy at $10 equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders. Rule 6440(f)(2) imposes similar requirements with respect to the receipt of customer limit orders in exchange-listed securities.

[4] See NASD Rule 2110.

[5] Rule 6440(f)(1) currently prohibits a member from personally buying (selling) an exchange-listed security for its own account while such member holds an unexecuted market order to buy (sell) such security for a customer. The proposed rule change would prohibit a broad range of conduct, including conduct prohibited by Rule 6440(f)(1) and therefore, NASD staff will recommend to Nasdaq that it consider deleting Rule 6440(f)(1), in light of the proposal described herein.

[6] The agency obligation of a broker/dealer with respect to a customer order is defined by the customer's expectation of the treatment of the order. A customer's market order generally represents the expectation that the order will be executed fully and promptly at the current best bid, for a sell order, or best offer, for a buy order, regardless of the impact on market price. In attempting to meet this expectation, there is some reasonable period of time in which market orders may queue while the broker/dealer is executing orders ahead on both sides of the market. This proposed rule change represents NASD's view that, when that reasonable time period has expired, the member shall not be permitted to trade that security for its own account on the same side of the market as its customer market order without giving the customer market order an execution at that same price or better.

orders received from the member’s own customers or customer orders of another broker/dealer. In addition, if a customer market order has not been executed fully and promptly, a member would be required to match the pending market order against any subsequent market orders or marketable limit orders on the other side of the market received by the member up to the size of the pending market order and at a price that is equal to or better than the best bid for a pending market order to buy or the best offer for a pending market order to sell.

In the event that a member has multiple orders on both sides of the market that have not been executed fully and promptly, the member must have a written methodology in place describing the way in which the member will cross or otherwise execute such orders that is reasonable and is consistent with the objectives of this rule. The member also must ensure that such methodology is consistently applied to all such pending orders.

For example, assume the inside market for security ABCD is 10 to 10.05 and Firm A receives a market order to buy 1,000 shares of ABCD from Customer C1, which Firm A has not executed fully and promptly. If Firm A buys 1,000 shares of ABCD at 10 from Firm B (or from any other source), Firm A would be required to sell 1,000 shares of ABCD to C1 at 10. Similarly, if Firm A bought shares for its own account below the best bid of 10, it would be required to sell stock to C1 at that same price below the bid or better.

Under the same facts described above, if Firm A subsequently receives a market order to sell 1000 shares of ABCD from Customer C2, Firm A would be required to cross the orders from C1 and C2 at the bid of 10.

If a member does not execute an order fully and promptly, but has not bought or sold securities for its own account on the same side of the market as the customer order or has not received a market order from another customer on the contra-side of the market, the proposed rule change would not impose any specific obligations on the member above and beyond the member's current obligations to market orders, such as a member's best execution requirements under Rule 2320.

The proposed rule change also would incorporate several of the same types of exclusions that apply to the Manning Rule. First, the proposed rule change would permit members to negotiate specific terms and conditions applicable to the acceptance of a market order with respect to a market order for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4) or a market order that is for 10,000 shares or more, unless such order is less than $100,000 in value.

Second, the proposal would provide an exception for member proprietary trades that are part of an execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the "facilitated order"). This exclusion would apply only if the following requirements are met: (1) the handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules; (2) the member must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee; (3) a member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) or 4632A(e)(1)(C)(ii), or a substantially similar report; and (4) members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with applicable NASD rules.[7]

For example, assume that the inside market for security ABCD is 10 to 10.05 and Firm A receives 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. Firm A does not execute the orders from C1 and C2 fully and promptly. 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 the proposed rule change, the riskless principal trade would not trigger an execution of C2's order under the proposed rule change. Under the same facts noted above, 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 the execution (or partial execution) of C1's order.[8]

The proposed rule change also applies to limit orders that are marketable at the time they are received by the member or that become marketable at a later time. Such limit orders would be

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7 With respect to requirement (4), the member's policies and procedures, at a minimum, must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner, all orders which a member relies in claiming this exemption.

8 Except as specifically provided in the proposed rule change, NASD has not mandated any particular order handling and execution priority procedures among market orders. Thus, a member may choose any reasonable methodology for the way in which it executes multiple orders that it holds, but the member must ensure that such methodology is applied consistently. For example, a member could use a first in first out (FIFO) methodology or some other objective methodology or formula. It would be inappropriate, however, for a member's methodology to give priority, for example, to orders of certain "preferred accounts" or preference institutional orders over retail orders. To the extent a member elects a specific methodology, the member must document that methodology and have written supervisory procedures and systems in place to ensure that the methodology it has chosen is consistent with the duty of best execution. Further, simply because a member employs a methodology for execution of orders and that methodology is followed in a particular circumstance

treated as market orders for purposes of the proposed rule change, however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit order must be provided the full protections of IM-2110-2 for Nasdaq securities or Rule 6440(f)(2) for exchange-listed securities. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or Rule 6440(f)(2).

The proposed rule change applies to NASD members irrespective of upon which market they trade. If a member were to execute a proprietary trade on an exchange while holding a customer market order on the same side of the market that the member has not fully and promptly executed, then the member would be deemed to have violated the proposed rule change unless (1) the member immediately provides an execution to that market order at a price equal to or better than proprietary trade; or (2) the member's proprietary trade was in accordance with a functional role, recognized within the rules of that exchange, of acting as a liquidity provider, such as acting in the role of a specialist or some other substantially similar capacity.

NASD is emphasizing that nothing in the proposed rule change modifies the application of Rule 2320 with respect to a member's obligations to customer orders. For example, to the extent a member does not execute a market order fully and promptly, compliance with the proposed rule change would not safeguard the member from potential liability due to non-compliance with its best execution responsibilities.

Finally, in recognition that the proposed rule change may alter the way that many members handle customer orders, NASD believes it is important to provide members with adequate time to

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does not automatically mean that any or all customer orders executed pursuant to such a methodology have develop and implement systems to comply with the proposed rule change. Therefore, NASD is proposing an implementation date of 90 days after the issuance of a Notice to Members announcing SEC approval of the proposed rule change.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change will improve the treatment of market orders and enhance the integrity of the market.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such

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received best execution under NASD Rule 2320.

longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-XXXX-XXXX-XX. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary