OMB APPROVAL

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2004 - 045
Amendment No. 2

Proposed Rule Change by National Association of Securities Dealers

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

Initial	Amendment	Withdrawal	Section 19(b)(2)	Section 19(b)(3)(A)	Section 19(b)(3)(B)
☐	☑	☐	☑	☐	☐

Rule
☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐

Extension of Time Period for Commission Action ☐

Date Expires

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name: Andrea Last Name: Orr
Title: Assistant General Counsel
E-mail: andrea.orr@nasd.com
Telephone: (202) 728-8156 Fax: (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date: 08/03/2005

By: Stephanie Dumont
(Name)

Vice President and Associate General Counsel
(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

STEPHANIE DUMONT,

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

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") Amendment No. 2 to SR-NASD-2004-045, which would prohibit a member from trading ahead of a customer market order under certain circumstances. The purpose of this Amendment No. 2 is to address the comment letter received by the Commission in response to the publication of the proposed rule change in the Federal Register and to propose amendments responsive to the comments where appropriate.[1]

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

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.

(b) A member that accepts and holds a market order of its own customer or a customer of another broker-dealer in a Nasdaq or exchange-listed security without immediately executing the order is prohibited from trading that security on the same side of the market for its own account, unless it immediately thereafter executes the customer

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[1] See Exchange Act Release No. 51230 (Feb. 18, 2005), 70 FR 9408 (Feb. 25, 2005).

market order up to the size and at the same price at which it traded for its own account or at a better price.

(c) (1) A member that is holding a customer market order that has not been immediately executed must make every effort to cross such order with any market order, marketable limit order, or non-marketable limit order priced better than the best bid or offer, received by the member on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent market order, marketable limit order or non-marketable limit order is received by the member and that is consistent with the terms of the orders.

(2) 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 this rule and with the terms of the orders.

(3) For purposes of this paragraph (c), a member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

(4) A member must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of this rule. A member also must ensure that this methodology is consistently applied.

(d) 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.

(e) This rule applies 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.

(f) 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 broker-dealer) (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; 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. 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 on which a member relies in claiming this exception.

(g) 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

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. 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.

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

(a) Purpose

Rule Filing History

On March 12, 2004, NASD filed with the Commission proposed rule change SR-NASD-2004-045, proposing the adoption of NASD Rule 2111 (the "original filing") that would prohibit a member from trading ahead of a customer market order under the circumstances described therein. On February 16, 2005, NASD filed with the Commission Amendment No. 1 to SR-NASD-2004-045 ("Amendment No. 1"), which proposed to make certain clarifying changes to the original filing. On February 25, 2005, the Commission published for comment the proposed rule change in the Federal Register. Based on comments received in response to the publication of the proposed rule change in the Federal Register, NASD is filing this Amendment No. 2 to SR-NASD-2004-045

("Amendment No. 2") to respond to the comments received and to make certain changes as described herein.

Proposal

As described in the original filing and Amendment No. 1, NASD is proposing new Rule 2111, which would prohibit a member 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, unless it immediately thereafter executes the customer market order up to the size and at the same price or better at which it traded for its own account. In addition, if a member is holding a customer market order that has not been immediately executed, such member would be required to 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 up to the size of the pending market order and at a price that is no less than the best bid and no greater than the best offer at the time the subsequent order is received by the member, consistent with the terms of the pending 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 proposed rule change and with the terms of the orders. The member also must have a written methodology in place governing the execution priority of all such pending orders and must ensure that such methodology is consistently applied.

Comments to the Proposed Rule Change

The Commission received one comment letter in response to the publication of the proposed rule change in the Federal Register.[2] The commenter raised several issues relating to the proposed rule change, which are summarized and responded to below.

Requirement that Members Cross Standing Customer Market Orders

First, the commenter suggests that where a member holds a customer market order that has not been immediately executed and it can be matched with another order on the opposite side of the market, the member should not be limited to executing the two orders on an agency basis, but should be permitted to execute such orders by other means consistent with the proposed rule. NASD agrees that a member holding one or multiple orders on each side of the market may meet the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price. Therefore, NASD is amending the text of proposed Rule 2111(c) to clarify its original intent that a member holding a customer market order that has not been immediately executed or a member holding multiple orders on both sides of the market may satisfy the crossing requirements under the rule by contemporaneously buying from the seller and selling to the buyer at the same price.

The commenter also expressed concern that the proposal could require a member to cross a marketable limit order even if that limit order was marketable only for a brief period of time due to "flickering quotes." While NASD recognizes the technological challenges that can arise as a result of flickering quotations, in which the price of a quotation can change multiple times in a single second, NASD believes that this does not raise any unique issues with regard to the application of the proposed rule change. Because the proposal would require the matching of both marketable and non-marketable limit orders that would meet the requirements of the pending market order, the changing marketability or non-marketability of a particular limit order as a result of "flickering quotes" is not an issue. NASD recognizes that flickering quotes may increase the difficulty in determining the appropriate price of a market order, but such quotes will not, however, dictate whether a particular marketable or non-marketable limit order should be crossed pursuant to the proposed rule. Accordingly, NASD does not believe any amendments to the rule text are warranted to address this comment.

Applicability of Proposed Rule 2111 to Certain Order Types

The commenter asserted that the provisions of proposed Rule 2111 should not apply to orders that are entered on a "not held" basis and orders executed on an agency basis where the customer specifically asks that the order be executed on an agency basis or orders for accounts where the member is bound by another regulation limiting or prohibiting principal transactions.

First, with respect to orders accepted by a member on a "not held" basis, NASD believes that orders in which a customer has granted the member discretion with respect to time or price would not be considered a "market" order for the purposes of this rule and therefore would not be subject to the requirements described herein. However, this

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[2] See Letter dated May 27, 2005 from the Securities Industry Association (SIA), Ad Hoc Best Execution/Manning Committee.

in no way would change a member's best execution obligations with respect to the order under NASD Rule 2320.

Second, with respect to orders for accounts where the member is bound by another regulation limiting or prohibiting principal transactions with customer orders, consistent with prior interpretations concerning the application of NASD Interpretive Material 2110-2 (the "Manning Rule"),[3] the obligation to execute a trade with a customer following a separate proprietary trade on the same side of the market would not apply, if the order subject to these restrictions was sent to another broker-dealer for execution. In the event that such orders are not routed elsewhere for execution, the member would be required to comply with the requirements of Rule 2111. Similarly, with respect to orders where a customer has requested an order be executed on an agency basis, but where no other regulation limits or prohibits a principal transaction, the proposed rule would apply. Again, this would in no way change a member's best execution obligations to these orders under NASD Rule 2320.

Applicability of Proposed Rule 2111 to Certain Markets

The commenter states that the proposed rule change should apply only to orders executed on Nasdaq or the Over-the-Counter (OTC) market, indicating that the proposal may be duplicative of existing regulation by other markets. As discussed in the rule filing, the proposed rule change is based on a member's obligations relating to just and

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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.

equitable principles of trade with respect to the treatment of customer market orders. As such, NASD believes proposed NASD Rule 2111 should apply to the treatment of customer market orders in Nasdaq and exchange-listed securities by NASD members regardless of where the order ultimately is executed. Therefore, NASD does not believe any amendments to the rule text are warranted to address this comment.[4]

Information Barriers

The commenter suggests that the proposed rule change should allow firms to utilize more fully information barriers to segregate non-market making desks from other customer order flows. With respect to the application of the Manning Rule, NASD has issued guidance concerning the extent to which a trading desk other than the firm's market-making desk could trade for its own account while the market-making desk held protected customer limit orders on its books.[5] NASD believes this same guidance would apply with respect to the proposed rule. As noted in Notice to Members 03-74, NASD will continue to examine and review members using 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

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4 As noted in the original filing, 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 the 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.

not able to benefit from the information regarding trading by institutional accounts at other desks.

Other Clarifying Changes

NASD also is making two clarifying changes. First, NASD is amending proposed Rule 2111(c) to clarify that a member's obligation to have a written methodology in place governing the execution and priority of all pending orders applies whether a member is holding one order or multiple orders on both sides of the market. Second, NASD is amending proposed Rule 2111(f) to clarify that the facilitated order exception to the proposed rule includes orders received from the member's own customers or customer orders of another broker-dealer, consistent with the general application of the rule under paragraph (b).

(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 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

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[5] See Notice to Members 95-43 (June 1995) and Notice to Members 03-74 (November 2003).

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 on the proposed rule change were solicited by the Commission in response to SR-NASD-2004-045, which proposed to prohibit members from trading ahead of a customer market order under certain circumstances. The Commission received one comment letter in response to the Federal Register publication of SR-NASD-2004-045. The comments are summarized above.

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.

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

NASD requests the Commission to find good cause pursuant to Section 19(b)(2) of the Act for approving the proposed rule change prior to the 30th day after its publication in the Federal Register.

Because NASD believes the proposed rule change will improve the treatment of market orders and clarify the application of market order protection requirements, NASD requests the Commission to accelerate the effectiveness of the proposed rule change prior to the 30th day after its publication in the Federal Register.

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

Not applicable.

9. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 4. Exhibit 4 shows the full text of rule change marking changes from Amendment No. 1, with Amendment No. 1 changes shown as if adopted, and the new language in this Amendment No. 2 marked to show additions and deletions.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2004-045)
SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc.
Relating to the Adoption of NASD Rule 2111 to Prohibit Members from Trading Ahead of Customer Market Orders

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") Amendment No. 2 to the proposed rule change[3] 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. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

I. <u>Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change</u>

NASD is proposing to adopt NASD Rule 2111 to prohibit members from trading ahead of a customer market order under the circumstances described herein. Below is the

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

2 17 CFR 240.19b-4.

3 On March 12, 2004, NASD filed SR-NASD-2004-045 with the Commission. On February 16, 2005, NASD filed with the Commission Amendment No. 1 to SR-NASD-2004-045 that replaced and superseded in its entirety the text of the original rule filing.

text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

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.

(b) A member that accepts and holds a market order of its own customer or a customer of another broker-dealer in a Nasdaq or exchange-listed security without immediately executing the order is prohibited from trading that security on the same side of the market for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or at a better price.

(c) (1) A member that is holding a customer market order that has not been immediately executed must make every effort to cross such order with any market order, marketable limit order, or non-marketable limit order priced better than the best bid or offer, received by the member on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent market order, marketable limit order or non-marketable limit order is received by the member and that is consistent with the terms of the orders.

(2) 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 this rule and with the terms of the orders.

(3) For purposes of this paragraph (c), a member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

(4) A member must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of this rule. A member also must ensure that this methodology is consistently applied.

(d) 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.

(e) This rule applies 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.

(f) 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 broker-dealer) (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; 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. 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 on which a member relies in claiming this exception.

(g) 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

Rule Filing History

On March 12, 2004, NASD filed with the Commission proposed rule change SR-NASD-2004-045, proposing the adoption of NASD Rule 2111 (the "original filing") that would prohibit a member from trading ahead of a customer market order under the circumstances described therein. On February 16, 2005, NASD filed with the Commission Amendment No. 1 to SR-NASD-2004-045 ("Amendment No. 1"), which proposed to make certain clarifying changes to the original filing. On February 25, 2005, the Commission published for comment the proposed rule change in the Federal Register. Based on comments received in response to the publication of the proposed rule change in the Federal Register, NASD is filing this Amendment No. 2 to SR-NASD-2004-045 ("Amendment No. 2") to respond to the comments received and to make certain changes as described herein.

Proposal

As described in the original filing and Amendment No. 1, NASD is proposing new Rule 2111, which would prohibit a member 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, unless it immediately thereafter executes the customer market order up to the size and at the same price or better at which it traded for its own account. In addition, if a member is holding a customer market order that has not been immediately executed, such member would be required to 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 up to the size of the pending market order and at a price that is no less than the best bid and no greater than the best offer at the time the subsequent order is received by the member, consistent with the terms of the pending 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 proposed rule change and with the terms of the orders. The member also must have a written methodology in place governing the execution priority of all such pending orders and must ensure that such methodology is consistently applied.

Comments to the Proposed Rule Change

The Commission received one comment letter in response to the publication of the proposed rule change in the Federal Register.[4] The commenter raised several issues relating to the proposed rule change, which are summarized and responded to below.

Requirement that Members Cross Standing Customer Market Orders

First, the commenter suggests that where a member holds a customer market order that has not been immediately executed and it can be matched with another order on the opposite side of the market, the member should not be limited to executing the two orders on an agency basis, but should be permitted to execute such orders by other means consistent with the proposed rule. NASD agrees that a member holding one or multiple orders on each side of the market may meet the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price. Therefore, NASD is amending the text of proposed Rule 2111(c) to clarify its original intent that a member holding a customer market order that has not been immediately executed or a member holding multiple orders on both sides of the market may satisfy the crossing requirements under the rule by contemporaneously buying from the seller and selling to the buyer at the same price.

The commenter also expressed concern that the proposal could require a member to cross a marketable limit order even if that limit order was marketable only for a brief period of time due to "flickering quotes." While NASD recognizes the technological challenges that can arise as a result of flickering quotations, in which the price of a

4 See Letter dated May 27, 2005 from the Securities Industry Association (SIA), Ad Hoc Best Execution/Manning Committee.

quotation can change multiple times in a single second, NASD believes that this does not raise any unique issues with regard to the application of the proposed rule change. Because the proposal would require the matching of both marketable and non-marketable limit orders that would meet the requirements of the pending market order, the changing marketability or non-marketability of a particular limit order as a result of "flickering quotes" is not an issue. NASD recognizes that flickering quotes may increase the difficulty in determining the appropriate price of a market order, but such quotes will not, however, dictate whether a particular marketable or non-marketable limit order should be crossed pursuant to the proposed rule. Accordingly, NASD does not believe any amendments to the rule text are warranted to address this comment.

Applicability of Proposed Rule 2111 to Certain Order Types

The commenter asserted that the provisions of proposed Rule 2111 should not apply to orders that are entered on a "not held" basis and orders executed on an agency basis where the customer specifically asks that the order be executed on an agency basis or orders for accounts where the member is bound by another regulation limiting or prohibiting principal transactions.

First, with respect to orders accepted by a member on a "not held" basis, NASD believes that orders in which a customer has granted the member discretion with respect to time or price would not be considered a "market" order for the purposes of this rule and therefore would not be subject to the requirements described herein. However, this in no way would change a member's best execution obligations with respect to the order under NASD Rule 2320.

Second, with respect to orders for accounts where the member is bound by another regulation limiting or prohibiting principal transactions with customer orders, consistent with prior interpretations concerning the application of NASD Interpretive Material 2110-2 (the "Manning Rule"),[5] the obligation to execute a trade with a customer following a separate proprietary trade on the same side of the market would not apply, if the order subject to these restrictions was sent to another broker-dealer for execution. In the event that such orders are not routed elsewhere for execution, the member would be required to comply with the requirements of Rule 2111. Similarly, with respect to orders where a customer has requested an order be executed on an agency basis, but where no other regulation limits or prohibits a principal transaction, the proposed rule would apply. Again, this would in no way change a member's best execution obligations to these orders under NASD Rule 2320.

Applicability of Proposed Rule 2111 to Certain Markets

The commenter states that the proposed rule change should apply only to orders executed on Nasdaq or the Over-the-Counter (OTC) market, indicating that the proposal may be duplicative of existing regulation by other markets. As discussed in the rule filing, the proposed rule change is based on a member's obligations relating to just and equitable principles of trade with respect to the treatment of customer market orders. As such, NASD believes proposed NASD Rule 2111 should apply to the treatment of customer market orders in Nasdaq and exchange-listed securities by NASD members

5 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.

regardless of where the order ultimately is executed. Therefore, NASD does not believe any amendments to the rule text are warranted to address this comment.[6]

Information Barriers

The commenter suggests that the proposed rule change should allow firms to utilize more fully information barriers to segregate non-market making desks from other customer order flows. With respect to the application of the Manning Rule, NASD has issued guidance concerning the extent to which a trading desk other than the firm's market-making desk could trade for its own account while the market-making desk held protected customer limit orders on its books.[7] NASD believes this same guidance would apply with respect to the proposed rule. As noted in Notice to Members 03-74, NASD will continue to examine and review members using 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 benefit from the information regarding trading by institutional accounts at other desks.

Other Clarifying Changes

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6 As noted in the original filing, 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 the 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.

7 See Notice to Members 95-43 (June 1995) and Notice to Members 03-74 (November 2003).

NASD also is making two clarifying changes. First, NASD is amending proposed Rule 2111(c) to clarify that a member's obligation to have a written methodology in place governing the execution and priority of all pending orders applies whether a member is holding one order or multiple orders on both sides of the market. Second, NASD is amending proposed Rule 2111(f) to clarify that the facilitated order exception to the proposed rule includes orders received from the member's own customers or customer orders of another broker-dealer, consistent with the general application of the rule under paragraph (b).

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 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. <u>Self-Regulatory Organization's Statement on Burden on Competition</u>

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

Written comments on the proposed rule change were solicited by the Commission in response to SR-NASD-2004-045, which proposed to prohibit members from trading ahead of a customer market order under certain circumstances. The Commission received one comment letter in response to the Federal Register publication of SR-NASD-2004-045. The comments are summarized above.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) of the Act for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NASD and, in particular, the requirements of Section 15A of the Act and the rules and regulations thereunder. The Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in that accelerated approval will improve the treatment of market orders and clarify the application of market order protection requirements.

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 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. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-045 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2001.

All submissions should refer to File Number SR-NASD-2004-045. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). 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, 100 F Street, NE, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2004-045 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[8]

Secretary

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[8] 17 CFR 200.30-3(a)(12).

EXHIBIT 4

Exhibit 4 shows the full text of rule change marking changes from Amendment No. 1 to SR-NASD-2004-045 to this Amendment No. 2, with the language in Amendment No. 1 shown as if adopted, and the new language in this Amendment No. 2 marked to show additions and deletions.

Proposed new language is underlined
Proposed deletions are in brackets

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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.

(b) A member that accepts and holds a market order of its own customer or a customer of another broker-dealer in a Nasdaq or exchange-listed security without immediately executing the order is prohibited from trading that security on the same side of the market for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or at a better price.

(c) <u>(1)</u> A member that is holding a customer market order that has not been immediately executed must make every effort to cross such order with any market order, marketable limit order, or non-marketable limit order priced better than the best bid or offer, received by the member on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent market order, marketable limit order or non-marketable limit order is received by the member and that is consistent with the terms of the orders.

<u>(2)</u> 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 this rule and with the terms of the orders.

<u>(3) For purposes of this paragraph (c), a member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.</u>

<u>(4)</u> [The]<u>A</u> member must have a written methodology in place governing the execution and priority of all [such]pending orders <u>that is consistent with the requirements of this rule. A member</u> [and]<u>also</u> must ensure that [such]<u>this</u> methodology is consistently applied.

(d) 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.

(e) This rule applies 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.

(f) 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]<u>broker-dealer</u>) (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; 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. 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 on which a member relies in claiming this exception.

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