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

File No. SR - 2005 - 146

Amendment No.

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).

Proposal to expand the scope of IM-2110-2 relating to trading ahead of customer limit orders to apply to all OTC equity securities.

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: 12/09/2005

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") a proposed rule change to expand the scope of Interpretive Material (IM) 2110-2 relating to trading ahead of customer limit orders to apply to all over-the-counter ("OTC") equity securities.

Below is the text of the proposed rule change.[1] Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

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

(a) General Applications

To continue to ensure investor protection and enhance market quality, NASD's Board of Governors is issuing an interpretation to NASD Rules dealing with member firms' treatment of their customer limit orders in <u>equity</u>[Nasdaq and exchange-listed] securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not "trade ahead" of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received

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1 The rule text reflects amendments to IM-2110-2 that have been recently approved by the SEC, but are not yet effective. These amendments will become effective on January 2, 2006. <u>See</u> Securities Exchange Act Release No. 52210 (August 4, 2005); 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089). <u>See also</u> <u>Notice to Members</u> 05-64 (October 2005). Note: NASD has not included this footnote in Exhibit 1 hereto in the event that the SEC publishes notice of this proposed rule change in the <u>Federal Register</u> after January 2, 2006, which would make the footnote unnecessary.

from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. In the interests of investor protection, NASD is eliminating the so-called disclosure "safe harbor" previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm.[1] For purposes of this interpretation, "equity security" means any equity security that is listed on The Nasdaq Stock Market or a national securities exchange or meets the definition of OTC Equity Security as defined in the Rule 6600 Series.

Rule 2110 states that:

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Rule 2320, the Best Execution Rule, states that:

In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

Interpretation

The following interpretation of Rule 2110 has been approved by the Board:

A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in [a]an equity [Nasdaq or exchange-listed] security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than $100,000 in value. In the event that a member acting as market maker trades ahead of an unexecuted customer limit order at a price that is better than the unexecuted limit order, such member is required to execute the limit order at the price received by the member or better. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, NASD wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. NASD believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm's market-making capacity does not occur.

As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis when holding an unexecuted limit order for a Nasdaq security trading in fractions, and not be required to execute the held limit order, is as follows:

- If actual spread is greater than 1/16 of a point, a firm must price improve an incoming order by at least a 1/16. For stocks priced under $10 (which are quoted in 1/32 increments), the firm must price improve by at least 1/64.
- If actual spread is the minimum quotation increment, a firm must price improve an incoming order by one-half the minimum quotation increment.

For Nasdaq securities authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, and not be required to execute the held limit order, as follows:

1) For customer limit orders priced at or inside the best inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

2) For customer limit orders priced outside the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming order at a price at least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01)

NASD also wishes to emphasize that all members accepting customer limit orders owe those customers duties of "best execution" regardless of whether the orders are executed through the member's market-making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. NASD emphasizes that order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

(b) through (c) No change.

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[1] For purposes of the operation of certain Nasdaq transaction and quotation reporting systems and facilities during the period from 4 p.m. to 6:30 p.m. Eastern Time, members may generally limit the life of a customer limit order to the period of 9:30 a.m. to 4 p.m. Eastern Time. If a customer does not formally assent ("opt-in") to processing of the customer's limit order(s) during the extended hours period commencing after the normal close of the Nasdaq market, limit order protection will not apply to that customer's order(s).

* * * * *

6541. [Limit Order Protection]<u>Reserved.</u>

[(a) Members shall be prohibited from "trading ahead" of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.]

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

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

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

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

[(d) Contemporaneous trades]

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

[(e) Application]

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

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

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on September 21, 2005, 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. The Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on September 22, 2005. 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 Board of Governors of NASD to adopt amendments to 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

Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule") generally prohibits a member from trading for its own account at prices that would satisfy a customer's limit order, unless the member immediately thereafter executes the customer limit order.[2] The legal underpinnings for the Manning Rule are a member's basic fiduciary obligations and the requirement that a member must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."[3]

IM-2110-2 applies to Nasdaq and exchange-listed securities,[4] but does not apply to OTC equity securities. Rule 6541, however, extends the general principles of the Manning Rule to a subset of OTC equity securities, those that are quoted on the OTC Bulletin Board ("OTCBB"), but differs from the Manning Rule in several respects, which are described in more detail below.

NASD is proposing to expand the scope of the Manning Rule and any interpretive guidance thereunder to include OTC equity securities. NASD believes that customer limit orders in OTC equity securities should be subject to the same order handling and customer protection requirements under the Manning Rule as Nasdaq and exchange-listed securities. Given this proposed expansion of IM-2110-2 to OTC equity securities, NASD also is proposing to repeal Rule 6541. As noted above, although Rule 6541 is substantially similar to the Manning Rule, it differs in its application in several ways.

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2 For example, if a member buys 100 shares of a security at $10 per share when holding customer limit orders in the same security to buy at $10 per share equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders.

3 See NASD Rule 2110.

4 The SEC recently approved the expansion of IM-2110-2 to exchange-listed securities. See Securities Exchange Act Release No. 52210 (August 4, 2005); 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089). See Notice to Members 05-64 (October 2005) (announcing SEC approval of amendments to IM-2110-2, which become effective January 2, 2006).

NASD believes that these distinctions in application no longer make sense and that having uniform limit order protection requirements across market sectors is appropriate. The most significant differences between IM-2110-2 and Rule 6541 are summarized below.

First, both the Manning Rule and Rule 6541 provide that a member is not deemed to have traded ahead of a customer limit order if the member provides a contemporaneous execution of the customer's order. For the purposes of the Manning Rule, contemporaneous has been interpreted to require execution as soon as possible, but absent reasonable and documented justification, within one minute.[5] In contrast, Rule 6541(d) provides a longer maximum time limit of five minutes, within which an execution of a customer order will be deemed to be contemporaneous with an execution for a member firm's account. The five-minute standard was intended to be an outside limit, absent extraordinary circumstances, and not a normal practice.[6] NASD believes that most customer limit orders are filled within a period shorter than five minutes following a proprietary triggering trade, and despite the more manual nature of the unlisted market, one minute is not an unreasonably short time to fill a customer order.

Second, both the Manning Rule and Rule 6541 permit members to negotiate terms and conditions on the acceptance of certain large-sized limit order. Such terms and conditions would permit the member to continue to trade along side of, or ahead of, the limit order, if the customer agrees. Rule 6541 applies a lower threshold requirement on

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

6 See Notice to Members 01-46 (July 2001).

the types of orders for which a member can negotiate such terms and conditions. Specifically, Rule 6541(c) only requires that an order be 10,000 shares or more and greater than $20,000 in value, while the Manning Rule requires that an order be 10,000 shares or more and greater than $100,000 in value. This lower threshold for OTCBB securities was established due to the lower average dollar amount of trades in OTCBB securities relative to trades in Nasdaq securities.

NASD believes the higher value threshold requirement under the Manning Rule should be applied to all securities uniformly. The value threshold of an order is intended to be an objective criteria upon which an assumption can be made that the order involves a best-efforts commitment and the commitment of substantial capital on the part of the member, and therefore, it is appropriate for the member to be able to place terms and conditions on the acceptance of that order. As such, NASD believes that it is the value and size of the customer order that is of significance in making this determination, not the average price of securities in a particular market sector.

Third, the Manning Rule excludes limit orders that are marketable at the time of receipt (marketable limit orders), whereas the requirements under Rule 6541 apply to such orders. This exclusion to the Manning Rule for marketable limit orders recognizes that marketable limit orders and market orders are functionally equivalent and, thus, customers placing marketable limit orders should not have an unwarranted advantage over market orders. If marketable limit orders were not excluded from the Manning Rule, the Rule’s operation could have the unintended consequence of providing marketable limit orders execution priority over market orders placed at the same time or prior to the marketable limit orders (commonly referred to as "jumping the queue").[7] As such, consistent with the current application of the Manning Rule, NASD staff believes that continuing to exclude marketable limit orders from the application of the Manning Rule is appropriate.[8]

Accordingly, NASD is proposing to apply limit order protection requirements uniformly to all equity securities by extending the scope of the Manning Rule to OTC equity securities.[9] In doing so, NASD also is proposing to repeal Rule 6541, as those requirements would be subsumed in the proposed expansion of the Manning Rule.

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. In recognition of the technological and systems changes the proposed rule change may require, the effective date will be 90 days following publication of the Notice to

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7 See Securities Exchange Act Release No. 41990 (October 7, 1999) (File No. SR-NASD-99-44).

8 Members also are restricted from trading ahead of marketable limit orders in Nasdaq and exchange-listed securities under recently approved Rule 2111, Trading Ahead of Customer Market Orders. Although Rule 2111 does not apply to OTC equity securities, it is consistent with a member's best execution obligations to execute marketable limit orders fully and promptly. Note: Rule 2111 becomes effective on January 9, 2006. See Securities Exchange Act Release No. 52226 (August 9, 2005); 70 FR 48219 (August 16, 2005) (File No. SR-NASD-2004-045). See also Notice to Members 05-69 (October 2005).

9 In addition to the differences between IM-2110-2 and Rule 6541 described above, the SEC recently approved amendments to IM-2110-2 that generally require a member that has traded ahead of a customer limit order at a price that is more favorable than the customer limit order price, to pass along that price improvement to the customer limit order. This requirement currently does not apply under Rule 6541. See Securities Exchange Act Release No. 52210 (August 4, 2005); 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089). See also Notice to Members 05-64 (October 2005).

Members announcing Commission approval.

NASD is seeking comment on the proposed implementation time. Specifically, NASD is seeking comment on whether 90 days from the publication of a Notice to Members is adequate time for implementation of the proposal given the manual nature of this marketplace. NASD is seeking comment on whether additional implementation time may be needed and the reasons therefor.

(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 treatment of customer limit orders and promote investor protection.

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.

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

Not applicable.

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 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2005-146)
SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc.
Relating to Proposal to Expand the Scope of IM-2110-2 Relating to Trading Ahead of Customer Limit Orders to Apply to All OTC Equity Securities

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 expand the scope of Interpretive Material (IM) 2110-2 relating to trading ahead of customer limit orders to apply to all over-the-counter ("OTC") equity securities.

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

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

2 17 CFR 240.19b-4.

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

(a) General Applications

To continue to ensure investor protection and enhance market quality, NASD's Board of Governors is issuing an interpretation to NASD Rules dealing with member firms' treatment of their customer limit orders in equity[Nasdaq and exchange-listed] securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not "trade ahead" of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. In the interests of investor protection, NASD is eliminating the so-called disclosure "safe harbor" previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm.[1] For purposes of this interpretation, "equity security" means any equity security that is listed on The Nasdaq Stock Market or a national securities exchange or meets the definition of OTC Equity Security as defined in the Rule 6600 Series.

Rule 2110 states that:

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Rule 2320, the Best Execution Rule, states that:

In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

Interpretation

The following interpretation of Rule 2110 has been approved by the Board:

A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in [a]<u>an equity</u> [Nasdaq or exchange-listed] security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than $100,000 in value. In the event that a member acting as market maker trades ahead of an unexecuted customer limit order at a price that is better than the unexecuted limit order, such member is required to execute the limit order at the price received by the member or better. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, NASD wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. NASD believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm's market-making capacity does not occur.

As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis when holding an unexecuted limit order for a Nasdaq security trading in fractions, and not be required to execute the held limit order, is as follows:

- If actual spread is greater than 1/16 of a point, a firm must price improve an incoming order by at least a 1/16. For stocks priced under $10 (which are quoted in 1/32 increments), the firm must price improve by at least 1/64.
- If actual spread is the minimum quotation increment, a firm must price improve an incoming order by one-half the minimum quotation increment.

For Nasdaq securities authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, and not be required to execute the held limit order, as follows:

1) For customer limit orders priced at or inside the best inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

2) For customer limit orders priced outside the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming order at a price at least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01)

NASD also wishes to emphasize that all members accepting customer limit orders owe those customers duties of "best execution" regardless of whether the orders are executed through the member's market-making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. NASD emphasizes that order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

(b) through (c) No change.

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1 For purposes of the operation of certain Nasdaq transaction and quotation reporting systems and facilities during the period from 4 p.m. to 6:30 p.m. Eastern Time, members may generally limit the life of a customer limit order to the period of 9:30 a.m. to 4 p.m. Eastern Time. If a customer does not formally assent ("opt-in") to processing of the customer's limit order(s) during the extended hours period commencing after the normal close of the Nasdaq market, limit order protection will not apply to that customer's order(s).

* * * * *

6541. [Limit Order Protection]<u>Reserved.</u>

[(a) Members shall be prohibited from "trading ahead" of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.]

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

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

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

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

[(d) Contemporaneous trades]

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

[(e) Application]

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

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

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II. <u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>

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. <u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>

1. Purpose

Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule") generally prohibits a member from trading for its 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 a member must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."[4]

IM-2110-2 applies to Nasdaq and exchange-listed securities,[5] but does not apply to OTC equity securities. Rule 6541, however, extends the general principles of the Manning Rule to a subset of OTC equity securities, those that are quoted on the OTC Bulletin Board ("OTCBB"), but differs from the Manning Rule in several respects, which are described in more detail below.

NASD is proposing to expand the scope of the Manning Rule and any interpretive guidance thereunder to include OTC equity securities. NASD believes that customer limit orders in OTC equity securities should be subject to the same order handling and customer protection requirements under the Manning Rule as Nasdaq and exchange-listed securities. Given this proposed expansion of IM-2110-2 to OTC equity securities, NASD also is proposing to repeal Rule 6541. As noted above, although Rule 6541 is substantially similar to the Manning Rule, it differs in its application in several ways.

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3 For example, if a member buys 100 shares of a security at $10 per share when holding customer limit orders in the same security to buy at $10 per share equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders.

4 <u>See</u> NASD Rule 2110.

5 The SEC recently approved the expansion of IM-2110-2 to exchange-listed securities. <u>See</u> Securities Exchange Act Release No. 52210 (August 4, 2005); 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089). <u>See</u> <u>Notice to Members</u> 05-64 (October 2005) (announcing SEC approval of amendments to IM-2110-2, which become effective January 2, 2006).

NASD believes that these distinctions in application no longer make sense and that having uniform limit order protection requirements across market sectors is appropriate. The most significant differences between IM-2110-2 and Rule 6541 are summarized below.

First, both the Manning Rule and Rule 6541 provide that a member is not deemed to have traded ahead of a customer limit order if the member provides a contemporaneous execution of the customer's order. For the purposes of the Manning Rule, contemporaneous has been interpreted to require execution as soon as possible, but absent reasonable and documented justification, within one minute.[6] In contrast, Rule 6541(d) provides a longer maximum time limit of five minutes, within which an execution of a customer order will be deemed to be contemporaneous with an execution for a member firm's account. The five-minute standard was intended to be an outside limit, absent extraordinary circumstances, and not a normal practice.[7] NASD believes that most customer limit orders are filled within a period shorter than five minutes following a proprietary triggering trade, and despite the more manual nature of the unlisted market, one minute is not an unreasonably short time to fill a customer order.

Second, both the Manning Rule and Rule 6541 permit members to negotiate terms and conditions on the acceptance of certain large-sized limit order. Such terms and conditions would permit the member to continue to trade along side of, or ahead of, the limit order, if the customer agrees. Rule 6541 applies a lower threshold requirement on the types of orders for which a member can negotiate such terms and conditions.

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

7 See Notice to Members 01-46 (July 2001).

Specifically, Rule 6541(c) only requires that an order be 10,000 shares or more and greater than $20,000 in value, while the Manning Rule requires that an order be 10,000 shares or more and greater than $100,000 in value. This lower threshold for OTCBB securities was established due to the lower average dollar amount of trades in OTCBB securities relative to trades in Nasdaq securities.

NASD believes the higher value threshold requirement under the Manning Rule should be applied to all securities uniformly. The value threshold of an order is intended to be an objective criteria upon which an assumption can be made that the order involves a best-efforts commitment and the commitment of substantial capital on the part of the member, and therefore, it is appropriate for the member to be able to place terms and conditions on the acceptance of that order. As such, NASD believes that it is the value and size of the customer order that is of significance in making this determination, not the average price of securities in a particular market sector.

Third, the Manning Rule excludes limit orders that are marketable at the time of receipt (marketable limit orders), whereas the requirements under Rule 6541 apply to such orders. This exclusion to the Manning Rule for marketable limit orders recognizes that marketable limit orders and market orders are functionally equivalent and, thus, customers placing marketable limit orders should not have an unwarranted advantage over market orders. If marketable limit orders were not excluded from the Manning Rule, the Rule's operation could have the unintended consequence of providing marketable limit orders execution priority over market orders placed at the same time or prior to the marketable limit orders (commonly referred to as "jumping the queue").[8] As such, consistent with the current application of the Manning Rule, NASD staff believes that continuing to exclude marketable limit orders from the application of the Manning Rule is appropriate.[9]

Accordingly, NASD is proposing to apply limit order protection requirements uniformly to all equity securities by extending the scope of the Manning Rule to OTC equity securities.[10] In doing so, NASD also is proposing to repeal Rule 6541, as those requirements would be subsumed in the proposed expansion of the Manning Rule.

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. In recognition of the technological and systems changes the proposed rule change may require, the effective date will be 90 days following publication of the Notice to Members

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8 See Securities Exchange Act Release No. 41990 (October 7, 1999) (File No. SR-NASD-99-44).

9 Members also are restricted from trading ahead of marketable limit orders in Nasdaq and exchange-listed securities under recently approved Rule 2111, Trading Ahead of Customer Market Orders. Although Rule 2111 does not apply to OTC equity securities, it is consistent with a member's best execution obligations to execute marketable limit orders fully and promptly. Note: Rule 2111 becomes effective on January 9, 2006. See Securities Exchange Act Release No. 52226 (August 9, 2005); 70 FR 48219 (August 16, 2005) (File No. SR-NASD-2004-045). See also Notice to Members 05-69 (October 2005).

10 In addition to the differences between IM-2110-2 and Rule 6541 described above, the SEC recently approved amendments to IM-2110-2 that generally require a member that has traded ahead of a customer limit order at a price that is more favorable than the customer limit order price, to pass along that price improvement to the customer limit order. This requirement currently does not apply under Rule 6541. See Securities Exchange Act Release No. 52210 (August 4, 2005); 70 FR 46897 (August 11, 2005) (File No. SR-NASD-2004-089). See also Notice to Members 05-64 (October 2005).

announcing Commission approval.

NASD is seeking comment on the proposed implementation time. Specifically, NASD is seeking comment on whether 90 days from the publication of a Notice to Members is adequate time for implementation of the proposal given the manual nature of this marketplace. NASD is seeking comment on whether additional implementation time may be needed and the reasons therefor.

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 treatment of customer limit orders and promote investor protection.

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 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-2005-146 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-2005-146. 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-2005-146 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.[11]

Secretary

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[11] 17 CFR 200.30-3(a)(12).