

OMB APPROVAL

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

File No. SR - 2006 - 035

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).

Proposed Amendments to IM-2110-2 to Clarify the Application of the Manning Rule to Non-Market Makers

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 Last Name
Title
E-mail
Telephone Fax
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 By
(Name)

(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 EDFS website.

Form 19b-4 Information

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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

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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

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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

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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

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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

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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

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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 amend NASD Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the “Manning Rule”), to codify NASD’s existing position that the Manning Rule applies to all members, whether acting as a market maker or not.

Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

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

(a) General Application

To continue to ensure investor protection and enhance market quality, NASD's Board of Governors is issuing an interpretation to NASD Rules dealing with member firms' treatment of their customer limit orders in 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 members[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

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 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 member[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 member[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, is 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 member[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 routinely the handling of their customers' limit orders regarding the quality of the execution received.

(b) Exclusion for Limit Orders that are Marketable at Time of Receipt

NASD[The Association] has previously recognized the functional equivalency of marketable limit orders and market orders. Accordingly, it has adopted the following interpretation. IM-2110-2 shall not apply to a customer limit order if the limit order is marketable at the time it is received by a member[market maker]. These orders shall be treated as market orders for purposes of determining execution priority; however, these orders must continue to be executed at their limit price or better.

The exclusion for marketable customer limit orders from the general application of IM-2110-2 is limited solely to customer limit orders that are marketable when received by a member[market maker]. If a customer limit order is not marketable when received by a member[market maker], the limit order must be accorded the full protections of IM-2110-2. 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 accorded the full protections of IM-2110-2.

The following scenario illustrates the application of the exclusion. The market in XYZ stock is 25 bid–25 1/16 ask, the volume of trading in XYZ stock is extremely active, and Market Maker A ("MMA") has a queue of market orders to buy and sell. Assume the following order receipt scenario. Each sell market order in the queue is for 1,000 shares and there are no special conditions attached to the orders. MMA then receives a customer limit order to sell 1,000 shares at 25. The customer limit order is marketable at the time it is received by MMA. MMA hits another market maker's bid at

25 for 1,000 shares. Normally, IM-2110-2 would require that the customer limit order be executed before the market orders in the queue. However, because the marketable limit order and the market orders should be treated as functionally equivalent in determining execution priority, the marketable customer limit order shall not be given execution priority over the market orders that were already in the queue. When the limit order is executed, however, it must be executed at the limit price or better.

In addition, if in the scenario just described the limit order does not get executed and the inside market in XYZ becomes 24 7/16 bid, the member[market maker] would have to protect the limit order as required by IM 2110-2 if the member[market maker] trades at the limit order price or better.

(c) Exemption for the Facilitation on a Riskless Principal Basis of Other Customer Orders

A member shall be exempt from the obligation to execute a customer limit order in a manner consistent with this interpretation if such member engages in trading activity to facilitate the execution, on a riskless principal basis, of another order from its customer (whether its own customer or the customer of another member) (the "facilitated order"), provided that all of the following requirements are satisfied:

(1) through (3) No change.

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exemption comply with NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B). 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 [Regulation] to accurately and readily reconstruct, in a time-sequenced manner, all orders on which a member relies in claiming this exemption.

¹ No change to text of footnote 1.

* * * * *

(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 November 17, 2004, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on November 18, 2004. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(iii) of Article VII of the NASD By-Laws permits the Board of Governors of NASD to adopt amendments to interpretations of NASD Rules without recourse to the membership for approval.

The proposed rule change will be effective immediately upon SEC approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory

Basis for, the Proposed Rule Change

(a) Purpose

The Manning Rule generally prohibits a member from trading for its own account in a Nasdaq or exchange-listed security at a price that is equal or better than an unexecuted customer limit order in that security, unless the member immediately thereafter executes the customer limit order at the price at which it traded for its own account or better.¹ The legal underpinnings for the Manning Rule are a member's basic fiduciary obligations and the requirement that it must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."²

The Manning Rule is designed to ensure that customer limit orders are executed in a fair manner by prohibiting a member firm from trading ahead of customers' limit orders in its principal capacity without executing the customer limit order. Currently, IM-2110-2 generally provides that members acting as a market makers are prohibited from trading for their own accounts at prices equal or superior to an unexecuted customer's limit order in that security without executing the customer limit order. Further, if the member acting as a market maker trades ahead of a customer limit order and receives a better price than the unexecuted customer limit order, the member acting as a market maker must fill the customer limit order at the price at which it traded for its own account or better. While the text of the Manning Rule is written specifically to

¹ For example, if a member bought 100 shares at \$10 when holding customer limit orders in the same security to buy at \$10 equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders.

² See NASD Rule 2110. See also NASD Rule 2320(a) (the "Best Execution Rule"). Note: NASD has proposed changes to the Best Execution Rule in SR-NASD-2004-026, which is currently pending at the SEC.

cover trading by market makers in their market-making capacity, NASD's longstanding position has been that the Manning Rule applies to all members (whether they are trading in a market making capacity or not) based on a member's best execution obligations.

For example, in Notices to Members 94-58 (July 15, 1994) and 95-43 (June 5, 1995), NASD provided guidance to member firms on the application of the Manning Rule to members not acting in a market making capacity. In the context of questions about whether a non-market maker holding a customer order can trade ahead of that limit order, NASD staff stated that it would be inconsistent with a member's best execution obligation for members to trade ahead of a customer's limit order even when not acting as a market maker.

In addition, the Manning Rule specifically states 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 and emphasizes that order entry firms should continue to monitor routinely the handling of their customers' limit orders regarding the quality of the execution received.

Accordingly, NASD is proposing to amend the Manning Rule to codify NASD's existing position and to state explicitly that all members are prohibited from trading for their own accounts at prices that would satisfy a customer's limit order, whether acting as a market maker or not. NASD believes that the proposed amendments will provide better clarity to members as to the application of the Manning Rule to trading by non-market

makers.³

Finally, NASD no longer refers to itself or its subsidiary, NASD Regulation, Inc., using its full corporate name, “the Association,” “the NASD” or “NASD Regulation, Inc.” Instead, NASD uses “NASD” unless otherwise appropriate for corporate or regulatory reasons. Accordingly, the proposed rule change replaces references to “Association” and “NASD Regulation” in the text of the proposed rule change with “NASD.”

The proposed rule change will be effective immediately upon SEC approval.

(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 clarify the application of the Manning Rule to non-market makers.

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.

³ It is important to note that the proposed clarification does not change the application of the Manning Rule to multiple trading desks within a member firm as described in Notice to Members 95-43 (June 5, 1995) and Notice to Members 03-74 (November 26, 2003).

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)

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 codify and clarify NASD's longstanding position that the Manning Rule applies to all members, whether acting as a market maker or not, 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 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2006-035)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Relating to Proposed Amendments to IM-2110-2 to Clarify the Application of the Manning Rule to Non-Market Makers

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. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend NASD Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the “Manning Rule”), to codify NASD’s existing position that the Manning Rule applies to all members, whether acting as a market maker or not.

Below is the text of the proposed rule change. Proposed new language is in

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

italics; proposed deletions are in brackets.

* * * * *

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

(a) General Application

To continue to ensure investor protection and enhance market quality, NASD's Board of Governors is issuing an interpretation to NASD Rules dealing with member firms' treatment of their customer limit orders in 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 members[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

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 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 member[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 member[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, is 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 member[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 routinely the handling of their customers' limit orders regarding the quality of the execution received.

(b) Exclusion for Limit Orders that are Marketable at Time of Receipt

NASD[The Association] has previously recognized the functional equivalency of marketable limit orders and market orders. Accordingly, it has adopted the following interpretation. IM-2110-2 shall not apply to a customer limit order if the limit order is marketable at the time it is received by a member[market maker]. These orders shall be treated as market orders for purposes of determining execution priority; however, these orders must continue to be executed at their limit price or better.

The exclusion for marketable customer limit orders from the general application of IM-2110-2 is limited solely to customer limit orders that are marketable when received by a member[market maker]. If a customer limit order is not marketable when received by a member[market maker], the limit order must be accorded the full protections of IM-2110-2. 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 accorded the full protections of IM-2110-2.

The following scenario illustrates the application of the exclusion. The market in XYZ stock is 25 bid–25 1/16 ask, the volume of trading in XYZ stock is extremely active, and Market Maker A ("MMA") has a queue of market orders to buy and sell. Assume the following order receipt scenario. Each sell market order in the queue is for 1,000 shares and there are no special conditions attached to the orders. MMA then receives a customer limit order to sell 1,000 shares at 25. The customer limit order is marketable at the time it is received by MMA. MMA hits another market maker's bid at 25 for 1,000 shares. Normally, IM-2110-2 would require that the customer limit order be executed before the market orders in the queue. However, because the marketable limit order and the market orders should be treated as functionally equivalent in determining execution priority, the marketable customer limit order shall not be given execution priority over the market orders that were already in the queue. When the limit order is executed, however, it must be executed at the limit price or better.

In addition, if in the scenario just described the limit order does not get executed and the inside market in XYZ becomes 24 7/16 bid, the member[market maker] would

have to protect the limit order as required by IM 2110-2 if the member[market maker] trades at the limit order price or better.

(c) Exemption for the Facilitation on a Riskless Principal Basis of Other Customer Orders

A member shall be exempt from the obligation to execute a customer limit order in a manner consistent with this interpretation if such member engages in trading activity to facilitate the execution, on a riskless principal basis, of another order from its customer (whether its own customer or the customer of another member) (the "facilitated order"), provided that all of the following requirements are satisfied:

(1) through (3) No change.

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exemption comply with NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B). 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 [Regulation] to accurately and readily reconstruct, in a time-sequenced manner, all orders on which a member relies in claiming this exemption.

¹ No change to text of footnote 1.

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

The Manning Rule generally prohibits a member from trading for its own account in a Nasdaq or exchange-listed security at a price that is equal or better than an unexecuted customer limit order in that security, unless the member immediately thereafter executes the customer limit order at the price at which it traded for its own account or better.³ The legal underpinnings for the Manning Rule are a member's basic fiduciary obligations and the requirement that it must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."⁴

The Manning Rule is designed to ensure that customer limit orders are executed in a fair manner by prohibiting a member firm from trading ahead of customers' limit orders in its principal capacity without executing the customer limit order. Currently,

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

⁴ See NASD Rule 2110. See also NASD Rule 2320(a) (the "Best Execution Rule"). Note: NASD has proposed changes to the Best Execution Rule in SR-NASD-2004-026, which is currently pending at the SEC.

IM-2110-2 generally provides that members acting as a market makers are prohibited from trading for their own accounts at prices equal or superior to an unexecuted customer's limit order in that security without executing the customer limit order.

Further, if the member acting as a market maker trades ahead of a customer limit order and receives a better price than the unexecuted customer limit order, the member acting as a market maker must fill the customer limit order at the price at which it traded for its own account or better. While the text of the Manning Rule is written specifically to cover trading by market makers in their market-making capacity, NASD's longstanding position has been that the Manning Rule applies to all members (whether they are trading in a market making capacity or not) based on a member's best execution obligations.

For example, in Notices to Members 94-58 (July 15, 1994) and 95-43 (June 5, 1995), NASD provided guidance to member firms on the application of the Manning Rule to members not acting in a market making capacity. In the context of questions about whether a non-market maker holding a customer order can trade ahead of that limit order, NASD staff stated that it would be inconsistent with a member's best execution obligation for members to trade ahead of a customer's limit order even when not acting as a market maker.

In addition, the Manning Rule specifically states 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 and emphasizes that order entry firms should continue to monitor routinely the handling of their customers' limit orders regarding the quality of the execution received.

Accordingly, NASD is proposing to amend the Manning Rule to codify NASD's existing position and to state explicitly that all members are prohibited from trading for their own accounts at prices that would satisfy a customer's limit order, whether acting as a market maker or not. NASD believes that the proposed amendments will provide better clarity to members as to the application of the Manning Rule to trading by non-market makers.⁵

Finally, NASD no longer refers to itself or its subsidiary, NASD Regulation, Inc., using its full corporate name, "the Association," "the NASD" or "NASD Regulation, Inc." Instead, NASD uses "NASD" unless otherwise appropriate for corporate or regulatory reasons. Accordingly, the proposed rule change replaces references to "Association" and "NASD Regulation" in the text of the proposed rule change with "NASD."

The proposed rule change will be effective immediately upon SEC approval.

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 clarify the application of the Manning Rule to non-market

⁵ It is important to note that the proposed clarification does not change the application of the Manning Rule to multiple trading desks within a member firm as described in Notice to Members 95-43 (June 5, 1995) and Notice to Members 03-74 (November 26, 2003).

makers.

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

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 codify and clarify NASD's longstanding position that the Manning Rule applies to all members, whether acting as a market maker or not.

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-2006-035 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-035. 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-2006-035 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.⁶

Nancy M. Morris

Secretary

⁶ 17 CFR 200.30-3(a)(12).