

OMB APPROVAL

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

File No. SR - 2007 - 041
Amendment No. 2

Proposed Rule Change by National Association of Securities Dealers
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☐	Amendment ☒	Withdrawal ☐	Section 19(b)(2) ☒	Section 19(b)(3)(A) ☐	Section 19(b)(3)(B) ☐
			Rule		
Pilot ☐	Extension of Time Period for Commission Action ☐	Date Expires 	☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3)	☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document
☐

Exhibit 3 Sent As Paper Document
☐

Description

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

Contact Information

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

First Name 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 officer.

Date

By
(Name)

Vice President and Director of Capital Markets Policy

(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

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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”),¹ Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 2 to SR-NASD-2007-041 (“Amendment No. 2”), which proposes to amend the minimum price-improvements standards set forth in NASD Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order.

Below is the text of the proposed rule change.² 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 NMS stocks and OTC equity securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members to handle their customer limit orders with all due care so that members do not “trade ahead” of those limit orders. Thus, members that handle customer limit

¹ 15 U.S.C. 78s(b)(1).

² The text of IM-2110-2 is based on the rule changes approved in SR-NASD-2005-146, which becomes effective 60 days after Commission approval of the proposed changes in this filing (SR-NASD-2007-041). See Securities Exchange Act Release No. 57133 (January 11, 2008), 73 FR 3500 (January 18, 2008) (notice of filing and immediate effectiveness of SR-FINRA-2007-038).

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, (1) “NMS stock” shall have the meaning set forth in SEC Rule 600(b)(47) of Regulation NMS and (2) “OTC equity security” shall have the meaning set forth in Rule 6610(d).

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 an NMS stock or OTC equity security and that continues to trade the subject security for its own 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 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 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.

The minimum amount of price improvement necessary [in order] for a member to execute an incoming order on a proprietary basis 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 greater than or equal to \$1.00 [that are at or inside the best inside], the minimum amount of price improvement required is \$0.01 for NMS stocks and the lesser of \$0.01 or one-half (1/2) of the current inside spread for OTC equity securities;

2) For customer limit orders priced greater than or equal to \$.01 and less than \$1.00 [that are at or inside the best inside market], the minimum amount of price improvement required is the lesser of \$0.01 or one-half (1/2) of the current inside spread;

3) [For customer limit orders priced outside the best inside market, the member must price improve the incoming order by executing the incoming order at a price at or inside the best inside market for the security; and]

[4) For customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required is \$0.01.]

For customer limit orders priced less than \$.01 but greater than or equal to \$0.001, the minimum amount of price improvement required is the lesser of \$0.001 or one-half (1/2) of the current inside spread;

4) For customer limit orders priced less than \$.001 but greater than or equal to \$.0001, the minimum amount of price improvement required is the lesser of \$0.0001 or one-half (1/2) of the current inside spread;

5) For customer limit orders priced less than \$.0001 but greater than or equal to \$.00001, the minimum amount of price improvement required is the lesser of \$0.00001 or one-half (1/2) of the current inside spread;

6) For customer limit orders priced less than \$.00001, the minimum amount of price improvement required is the lesser of \$.000001 or one-half (1/2) of the current inside spread; and

7) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the member must trade at a price at or inside the best inside market for the security.

If the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this IM, even if those better-priced limit orders would not be directly triggered under the minimum price-improvement standards above.

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 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 monitor routinely the handling of their customers’ limit orders regarding the quality of the execution received.

(b) and (c) No Change.

¹ No change to the footnote.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meeting on September 22, 2005, the Board of Governors of FINRA (then known as NASD) authorized the filing of the rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA proposes to implement the proposed rule change on the final implementation date of SR-NASD-2005-146, which will be 60 days after Commission approval of this filing.

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

(a) Purpose

Rule Filing History

On June 27, 2007, FINRA filed with the Commission SR-NASD-2007-041, proposing amendments to the minimum price-improvement provisions in IM-2110-2 ("original proposal"). On August 28, 2007, the SEC published for comment the proposed rule change in the Federal Register and received one commenter letter.³ On November 1, 2007, FINRA filed a letter with the SEC responding to the comment letter.⁴ On May 19, 2008, FINRA filed with the Commission Partial Amendment No. 1 to SR-NASD-2007-041. FINRA is filing this Amendment No. 2, which replaces and supersedes Partial Amendment No. 1 to SR-NASD-2007-041, to amend the proposed rule change to address

³ See Securities Exchange Act Release No. 56297 (August 21, 2007), 72 FR 49337 (August 28, 2007) (notice of filing of SR-NASD-2007-041). See also Letter from Jess Haberman, Compliance Director, Fidessa Corp.

⁴ Letter from Andrea Orr, FINRA, to Nancy M. Morris, Secretary, Commission, dated November 1, 2007 ("FINRA Response Letter").

an inconsistency in the application of the proposed minimum price-improvements standards as discussed herein.

Background and Proposal

On February 26, 2007, the Commission approved SR-NASD-2005-146, which, among other things, expanded the scope of IM-2110-2⁵ to apply to over-the-counter (“OTC”) equity securities and amended the minimum level of price-improvement that a member must provide to trade ahead of an unexecuted customer limit order (“price-improvement standards”). The rule changes in SR-NASD-2005-146 were initially scheduled to become effective on July 26, 2007.⁶

Following SEC approval of SR-NASD-2005-146, several firms raised concerns regarding the implementation timing of the rule change and the application of the approved minimum price-improvement standards. In response to these concerns, FINRA filed a proposed rule change to delay the effective date of the changes in SR-NASD-2005-146 pending its review of the amended price-improvement standards.⁷

⁵ Currently, IM-2110-2 generally prohibits a member from trading for its own account in an exchange-listed security at a price that is equal to 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.

⁶ See NASD Notice to Members 07-19 (April 2007).

⁷ See Securities Exchange Act Release No. 56103 (July 19, 2007), 72 FR 40918 (July 25, 2007) (notice of filing and immediate effectiveness of SR-NASD-2007-039). See also See Securities Exchange Act Release No. 56822 (November 20, 2007), 72 FR 67326 (November 28, 2007) (notice of filing and immediate effectiveness of SR-FINRA-2007-023); and Securities Exchange Act Release No. 57133 (January 11, 2008), 73 FR 3500 (January 18, 2008) (notice of filing and immediate effectiveness of SR-FINRA-2007-038).

Subsequently, FINRA filed SR-NASD-2007-041 with the Commission to further amend the price-improvement standards in IM-2110-2 based on new tiered standards that varied according to the price of the customer limit order. In response to the publication of the proposed rule change in the Federal Register, the Commission received one comment letter on the proposal.⁸

As further detailed in the FINRA Response Letter, the commenter noted an inconsistency in the application of proposed minimum price-improvement standards in low-priced securities when the customer limit order and the proprietary trade fall into different minimum price improvement tiers (e.g., a customer limit order to sell is priced at \$1.00 and the proprietary trade is at \$.998). For example, assume the best inside market for an NMS stock is \$.996 to \$1.00 and a firm is holding customer limit orders to sell at prices of \$.998 and \$1.00. If the firm sells for its own account at \$.996, only customer limit orders to sell priced below \$.998 and from \$1.00 up to, but not including, \$1.006 would be protected due to the firm's \$.996 triggering proprietary trade. As a result, the firm would not have an IM-2110-2 obligation to protect the more aggressively priced \$.998 customer limit order to sell (i.e., the minimum price improvement standard applicable to that order is the lesser of \$.01 or one-half (1/2) of the current inside spread (\$.002 (1/2 of \$.004)), such that the \$.996 proprietary trade would only trigger customer limit orders priced less than \$.998), but would have an obligation to protect the \$1.00 customer limit order to sell (i.e., the minimum price improvement standard applicable to that order is \$.01 such that a \$.996 proprietary trade would trigger customer limit orders priced at \$1.00 up to, but not including, \$1.006).

⁸ See supra, note 3.

In the FINRA Response Letter, FINRA indicated that firms may choose to voluntarily protect those more aggressively priced customer limit orders that fall within the gaps, which would not be an unreasonable policy or procedure and would be consistent with the principles underlying IM-2110-2 and the duty of best execution. However, upon further reflection, FINRA believes that it is important that the more aggressively priced customer limit orders also receive protection and that any potential “gaps” be eliminated. Therefore, FINRA is now proposing to require, and codify as part of IM-2110-2, that any more aggressively priced customer limit orders also receive protection. In other words, once a customer limit order is triggered under the rule, firms would be required to protect any more aggressively priced customer limit orders, even if those limit orders were not directly triggered by the minimum price improvement standards of IM-2110-2. FINRA is not, however, mandating any particular order handling procedures or execution priorities among protected orders. A firm may choose any reasonable methodology for the way in which it executes multiple orders triggered by the IM, but the firm must ensure that such methodology is applied consistently and complies with applicable rules and regulations.

Using the example above, once the limit order priced at \$1.00 is activated upon the execution of the firm’s trade at \$.996 (i.e., it is activated because it is within .01 of the price of the firm’s trade), a firm may implement a methodology that executes all more aggressively priced customer limit orders first (i.e., the limit order priced at \$.998) before executing the limit order priced at \$1.00. The proposed requirements would only apply in the limited circumstance where a firm has a limit order that is protected by IM-2110-2, but more aggressively priced customer limit orders are not protected. Therefore, in the

above example, if the firm was only holding a customer limit order to sell of \$.998 (and not a customer limit order of \$1.00), the \$.998 order would not be triggered by the proposed requirements.

Implementation

As noted above, FINRA proposes to implement the proposed rule change on the final implementation date of SR-NASD-2005-146, which will be 60 days after Commission approval of this filing.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁹ which requires, among other things, that FINRA 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. FINRA believes that the proposed rule change better reflects trading in low-priced securities and the application of IM-2110-2.

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

FINRA 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.

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

The proposed rule change was published for comment in the Federal Register and the SEC received one commenter letter, which was previously summarized and

⁹ 15 U.S.C. 78o-3(b)(6).

responded to in the FINRA Response Letter and therefore is not being included as part of this Amendment No. 2.¹⁰

6. Extension of Time Period for Commission Action

FINRA 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.¹¹

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 4. Exhibit 4 shows the full text of rule change marking changes from the original proposal, with the original proposal language changes shown as if adopted, and the new language in this Amendment No. 2 marked to show additions and deletions.¹²

¹⁰ See Letter from Jess Haberman, Compliance Director, Fidessa Corp.

¹¹ 15 U.S.C. 78s(b)(2).

¹² There are no proposed changes to the text of IM-2110-2 from Partial Amendment No. 1 to SR-NASD-2007-041 to this Amendment No. 2.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2007-041)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Minimum Price-Improvement Standards in IM-2110-2 (Trading Ahead of Customer Limit Order)

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 _____, _____, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 2 to SR-NASD-2007-041 as described in Items I, II, and III below, which Items have been prepared by FINRA. 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

FINRA is proposing to amend the minimum price-improvements standards set forth in NASD Interpretive Material (IM) 2110-2, Trading Ahead of Customer Limit Order.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Below is the text of the proposed rule change.³ Proposed new language is in 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 NMS stocks and OTC equity securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members to handle their customer limit orders with all due care so that members do not "trade ahead" of those limit orders. Thus, members 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, (1) "NMS stock" shall have the meaning set forth in SEC Rule 600(b)(47) of Regulation NMS and (2) "OTC equity security" shall have the meaning set forth in Rule 6610(d).

³ The text of IM-2110-2 is based on the rule changes approved in SR-NASD-2005-146, which becomes effective 60 days after Commission approval of the proposed changes in this filing (SR-NASD-2007-041). See Securities Exchange Act Release No. 57133 (January 11, 2008), 73 FR 3500 (January 18, 2008) (notice of filing and immediate effectiveness of SR-FINRA-2007-038).

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 an NMS stock or OTC equity security and that continues to trade the subject security for its own 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 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 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.

The minimum amount of price improvement necessary [in order] for a member to execute an incoming order on a proprietary basis 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 greater than or equal to \$1.00 [that are at or inside the best inside], the minimum amount of price improvement required is \$0.01 for NMS stocks and the lesser of \$0.01 or one-half (1/2) of the current inside spread for OTC equity securities;

2) For customer limit orders priced greater than or equal to \$.01 and less than \$1.00 [that are at or inside the best inside market], the minimum amount of price improvement required is the lesser of \$0.01 or one-half (1/2) of the current inside spread;

3) [For customer limit orders priced outside the best inside market, the member must price improve the incoming order by executing the incoming order at a price at or inside the best inside market for the security; and]

[4) For customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required is \$0.01.]

For customer limit orders priced less than \$.01 but greater than or equal to \$0.001, the minimum amount of price improvement required is the lesser of \$0.001 or one-half (1/2) of the current inside spread;

4) For customer limit orders priced less than \$.001 but greater than or equal to \$0.0001, the minimum amount of price improvement required is the lesser of \$0.0001 or one-half (1/2) of the current inside spread;

5) For customer limit orders priced less than \$.0001 but greater than or equal to \$0.00001, the minimum amount of price improvement required is the lesser of \$0.00001 or one-half (1/2) of the current inside spread;

6) For customer limit orders priced less than \$.00001, the minimum amount of price improvement required is the lesser of \$0.000001 or one-half (1/2) of the current inside spread; and

7) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the member must trade at a price at or inside the best inside market for the security.

If the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be

protected under this IM, even if those better-priced limit orders would not be directly triggered under the minimum price-improvement standards above.

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 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 monitor routinely the handling of their customers’ limit orders regarding the quality of the execution received.

(b) and (c) No Change.

¹ No change to the footnote.

* * * * *

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

In its filing with the Commission, FINRA 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. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

Rule Filing History

On June 27, 2007, FINRA filed with the Commission SR-NASD-2007-041, proposing amendments to the minimum price-improvement provisions in IM-2110-2 (“original proposal”). On August 28, 2007, the SEC published for comment the proposed rule change in the Federal Register and received one commenter letter.⁴ On November 1, 2007, FINRA filed a letter with the SEC responding to the comment letter.⁵ On May 19, 2008, FINRA filed with the Commission Partial Amendment No. 1 to SR-NASD-2007-041. FINRA is filing this Amendment No. 2, which replaces and supersedes Partial Amendment No. 1 to SR-NASD-2007-041, to amend the proposed rule change to address an inconsistency in the application of the proposed minimum price-improvements standards as discussed herein.

Background and Proposal

On February 26, 2007, the Commission approved SR-NASD-2005-146, which, among other things, expanded the scope of IM-2110-2⁶ to apply to over-the-counter (“OTC”) equity securities and amended the minimum level of price-improvement that a member must provide to trade ahead of an unexecuted customer limit order (“price-

⁴ See Securities Exchange Act Release No. 56297 (August 21, 2007), 72 FR 49337 (August 28, 2007) (notice of filing of SR-NASD-2007-041). See also Letter from Jess Haberman, Compliance Director, Fidessa Corp.

⁵ Letter from Andrea Orr, FINRA, to Nancy M. Morris, Secretary, Commission, dated November 1, 2007 (“FINRA Response Letter”).

⁶ Currently, IM-2110-2 generally prohibits a member from trading for its own account in an exchange-listed security at a price that is equal to 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.

improvement standards”). The rule changes in SR-NASD-2005-146 were initially scheduled to become effective on July 26, 2007.⁷

Following SEC approval of SR-NASD-2005-146, several firms raised concerns regarding the implementation timing of the rule change and the application of the approved minimum price-improvement standards. In response to these concerns, FINRA filed a proposed rule change to delay the effective date of the changes in SR-NASD-2005-146 pending its review of the amended price-improvement standards.⁸

Subsequently, FINRA filed SR-NASD-2007-041 with the Commission to further amend the price-improvement standards in IM-2110-2 based on new tiered standards that varied according to the price of the customer limit order. In response to the publication of the proposed rule change in the Federal Register, the Commission received one comment letter on the proposal.⁹

As further detailed in the FINRA Response Letter, the commenter noted an inconsistency in the application of proposed minimum price-improvement standards in low-priced securities when the customer limit order and the proprietary trade fall into different minimum price improvement tiers (e.g., a customer limit order to sell is priced

⁷ See NASD Notice to Members 07-19 (April 2007).

⁸ See Securities Exchange Act Release No. 56103 (July 19, 2007), 72 FR 40918 (July 25, 2007) (notice of filing and immediate effectiveness of SR-NASD-2007-039). See also See Securities Exchange Act Release No. 56822 (November 20, 2007), 72 FR 67326 (November 28, 2007) (notice of filing and immediate effectiveness of SR-FINRA-2007-023); and Securities Exchange Act Release No. 57133 (January 11, 2008), 73 FR 3500 (January 18, 2008) (notice of filing and immediate effectiveness of SR-FINRA-2007-038).

⁹ See supra, note 4.

at \$1.00 and the proprietary trade is at \$.998). For example, assume the best inside market for an NMS stock is \$.996 to \$1.00 and a firm is holding customer limit orders to sell at prices of \$.998 and \$1.00. If the firm sells for its own account at \$.996, only customer limit orders to sell priced below \$.998 and from \$1.00 up to, but not including, \$1.006 would be protected due to the firm's \$.996 triggering proprietary trade. As a result, the firm would not have an IM-2110-2 obligation to protect the more aggressively priced \$.998 customer limit order to sell (i.e., the minimum price improvement standard applicable to that order is the lesser of \$.01 or one-half (1/2) of the current inside spread (\$.002 (1/2 of \$.004))), such that the \$.996 proprietary trade would only trigger customer limit orders priced less than \$.998), but would have an obligation to protect the \$1.00 customer limit order to sell (i.e., the minimum price improvement standard applicable to that order is \$.01 such that a \$.996 proprietary trade would trigger customer limit orders priced at \$1.00 up to, but not including, \$1.006).

In the FINRA Response Letter, FINRA indicated that firms may choose to voluntarily protect those more aggressively priced customer limit orders that fall within the gaps, which would not be an unreasonable policy or procedure and would be consistent with the principles underlying IM-2110-2 and the duty of best execution. However, upon further reflection, FINRA believes that it is important that the more aggressively priced customer limit orders also receive protection and that any potential "gaps" be eliminated. Therefore, FINRA is now proposing to require, and codify as part of IM-2110-2, that any more aggressively priced customer limit orders also receive protection. In other words, once a customer limit order is triggered under the rule, firms would be required to protect any more aggressively priced customer limit orders, even if

those limit orders were not directly triggered by the minimum price improvement standards of IM-2110-2. FINRA is not, however, mandating any particular order handling procedures or execution priorities among protected orders. A firm may choose any reasonable methodology for the way in which it executes multiple orders triggered by the IM, but the firm must ensure that such methodology is applied consistently and complies with applicable rules and regulations.

Using the example above, once the limit order priced at \$1.00 is activated upon the execution of the firm's trade at \$.996 (i.e., it is activated because it is within .01 of the price of the firm's trade), a firm may implement a methodology that executes all more aggressively priced customer limit orders first (i.e., the limit order priced at \$.998) before executing the limit order priced at \$1.00. The proposed requirements would only apply in the limited circumstance where a firm has a limit order that is protected by IM-2110-2, but more aggressively priced customer limit orders are not protected. Therefore, in the above example, if the firm was only holding a customer limit order to sell of \$.998 (and not a customer limit order of \$1.00), the \$.998 order would not be triggered by the proposed requirements.

Implementation

As noted above, FINRA proposes to implement the proposed rule change on the final implementation date of SR-NASD-2005-146, which will be 60 days after Commission approval of this filing.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁰ which requires, among other things, that FINRA 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. FINRA believes that the proposed rule change better reflects trading in low-priced securities and the application of IM-2110-2.

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

FINRA 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.

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

The proposed rule change was published for comment in the Federal Register and the SEC received one commenter letter, which was previously summarized and responded to in the FINRA Response Letter and therefore is not being included as part of this Amendment No. 2.¹¹

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

¹⁰ 15 U.S.C. 78o-3(b)(6).

¹¹ See Letter from Jess Haberman, Compliance Director, Fidessa Corp.

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-2007-041 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-NASD-2007-041. 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. Copies of such filing also will be available for inspection and copying at the principal office of FINRA.

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 File Number SR-NASD-2007-041 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.¹²

Secretary

¹² 17 CFR 200.30-3(a)(12).

EXHIBIT 4

Exhibit 4 shows the changes proposed in this Amendment No. 2 marked against the original proposal, with the proposed changes in the original proposal shown as if adopted. Proposed new language in this Amendment No. 2 is underlined.

* * * *

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 NMS stocks and OTC equity securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members to handle their customer limit orders with all due care so that members do not "trade ahead" of those limit orders. Thus, members 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, (1) "NMS stock" shall have the meaning set forth in SEC Rule 600(b)(47) of Regulation NMS and (2) "OTC equity security" shall have the meaning set forth in Rule 6610(d).

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 an NMS stock or OTC equity security and that continues to trade the subject security for its own 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 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 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.

The minimum amount of price improvement necessary for a member to execute an incoming order on a proprietary basis 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 greater than or equal to \$1.00, the minimum amount of price improvement required is \$0.01 for NMS stocks and the lesser of \$0.01 or one-half (1/2) of the current inside spread for OTC equity securities;
- 2) For customer limit orders priced greater than or equal to \$.01 and less than \$1.00, the minimum amount of price improvement required is the lesser of \$0.01 or one-half (1/2) of the current inside spread;
- 3) For customer limit orders priced less than \$.01 but greater than or equal to \$0.001, the minimum amount of price improvement required is the lesser of \$0.001 or one-half (1/2) of the current inside spread;
- 4) For customer limit orders priced less than \$.001 but greater than or equal to \$0.0001, the minimum amount of price improvement required is the lesser of \$0.0001 or one-half (1/2) of the current inside spread;

5) For customer limit orders priced less than \$.0001 but greater than or equal to \$.00001, the minimum amount of price improvement required is the lesser of \$.00001 or one-half (1/2) of the current inside spread;

6) For customer limit orders priced less than \$.00001, the minimum amount of price improvement required is the lesser of \$.000001 or one-half (1/2) of the current inside spread; and

7) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the member must trade at a price at or inside the best inside market for the security.

If the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this IM, even if those better-priced limit orders would not be directly triggered under the minimum price-improvement standards above.

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 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 monitor routinely the handling of their customers’ limit orders regarding the quality of the execution received.

(b) and (c) No Change.

¹ No change to the footnote.