NASD Notice to Members 96-10

Expanded Limit-Order Protection Rule Gets Further Clarification By NASD

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Executive Summary

On September 6, 1995, the expanded Limit-Order Protection Interpretation to Article III, Section 1 of the NASD® Rules of Fair Practice that prohibits member firms from trading ahead of customer limit orders (commonly known as Manning II) became fully effective. The expanded Interpretation extends the scope of limit-order protection in The Nasdaq Stock Market℠ to ensure that all customer limit orders are afforded the same protection throughout Nasdaq®.

From June 21, 1995, to September 6, 1995, the Interpretation allowed a temporary phase-in period that permitted a market maker holding customer limit orders greater than 1,000 shares sent to it by another member firm (member-to-member orders) to trade at the same price as such limit order without protecting the limit order. On September 6, 1995, the temporary phase-in period expired. Since that date, all customer limit orders, whether they come from the firm's own customers or from another member firm's customers, must be handled in the same way by the firm accepting the limit order. That is, the member firm must not trade ahead of any customer limit order it holds without protecting that order.

Since the SEC approved the rule change in June 1995, the NASD has issued *Special Notice to Members 95-43* (June 5, 1995) and *Notice to Members 95-67* (August 1995) to provide guidance regarding a member's obligations under the Limit-Order Protection Interpretation. Since the Notices were issued, the NASD has continued to receive questions regarding the protection and reporting of limit orders handled on a net basis, defined as transactions where the customer wants the total transaction cost, inclusive of fees or commissions, to be set at a single price.

More Guidance Offered

Members have raised questions about the NASD's Question and Answer 2 in *Notice to Members 95-67*. In that discussion, the NASD addressed issues related to limit orders placed with a firm at a net price, and discussed the actual price at which the limit order must be protected. To reiterate the NASD's policy regarding a member firm's obligation regarding a net-price limit order, the NASD provides this guidance.

Assume that the inside market is 10 bid-10 1/2 offered. A customer places a 500-share order to buy with the firm, and states that he or she wants to trade net, with total transaction costs not to exceed 10 3/4. As stated in *Notice to Members 95-67*, Q. & A. 2, the firm must inform the customer of the specific price at which it will protect that order.

In this example, assume that the firm charges a markup of 1/2. The firm must inform the customer at the time of order entry that the limit order will be held and protected at 10 1/4. Under such circumstances, the Limit-Order Protection Interpretation requires that the firm must not buy for its own account at 10 1/4 or below, without filling the customer's order at the protected price, up to the number of shares that the firm has traded. For example, assume that while holding the 500-share limit order to buy at 10 1/4, the firm receives a market order to sell 500 shares in that security that the firm purchases at its bid of 10.

Because it has bought 500 shares at a price inferior to the 500-share limit order at 10 1/4, the firm must sell 500 shares to the customer with the limit at 10 1/4, i.e., the limit-order price agreed to between the customer and the market maker. The firm must report the trade through the Automated Confirmation Transaction (ACT℠)

service at 10 1/4, with the price exclusive of any markup or other remuneration. On the confirmation sent to the customer, the firm must disclose the reported trade price, 10 1/4, the price to the customer, 10 3/4, and the difference between them, 1/2, as the firm's remuneration for the transaction. This reporting is in compliance with the NASD trade-reporting rules under Schedule D, the SEC's confirmation disclosure requirements under Rule 10b-10, and is consistent with the original disclosure made to the customer at the time the order was entered.

Member firms are not permitted to report trade prices in such net transactions in a manner inconsistent with the stated agreement between the customer and the firm. Thus, in net transactions, after the customer and the firm have agreed to the actual limit price at which a limit order is protected, it is not permissible for a firm to report a trade with the customer at a price higher (lower) than the agreed-upon price in the context of a buy (sell) limit order and report a smaller markup (or markdown) on the confirm.

Another Example

Using the same example, assume the facts as above: the inside market is 10-10 1/2 and a customer places an order to buy 500 shares at a net price of 10 3/4; the firm then informs the customer that it will protect that order at 10 1/4 with a markup of 1/2. Assume again that the market maker holding such order buys for its own account at 10. At this point, the firm immediately fills the limit order because of its Manning obligation. It is **not** permissible to report the sale to the customer pursuant to the limit order at 10 1/2 (or at any other price higher than 10 1/4) and report only a markup of 1/4, or less, because such report improperly reflects an inaccurate markup and the reported trade price is incorrect because it includes a markup. Transaction reports through ACT must exclude markups, markdowns, and other such remuneration, and under Rule 10b-10, the confirmation must disclose the full markup, markdown, or other remuneration to the customer. Any practices to the contrary would be inconsistent with these requirements.

Nothing in this discussion is intended to keep a firm from providing the customer an execution at a more favorable price. Thus, if in the above examples the firm had an opportunity to provide the customer with an execution at a price better than 10 1/4, e.g., 10 1/8, the firm is permitted to execute and report the trade at the improved price.

Questions regarding this Notice should be directed to NASD Market Surveillance at (800) 925-8156.