Regulatory Notice 08-31

Trading Ahead of Customer Orders

SEC Approves Exemption from the Requirements in NASD IM-2110-2 and NASD Rule 2111 for Certain Regulation NMS-Compliant Intermarket Sweep Orders

Effective Date: May 6, 2008

Executive Summary

Effective May 6, 2008, the requirements in NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) do not apply to certain proprietary trades that are the result of intermarket sweep orders.[1] The text of the amended rules is set forth in Attachment A of this *Notice*.

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126; or the Office of General Counsel at (202) 728-8071.

Financial Industry Regulatory Authority

June 2008

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Operations
- Senior Management
- Systems
- Trading
- Training

Key Topic(s)

- Intermarket Sweep Orders
- Limit Orders
- Limit Order Protection
- Manning Rule
- Market Orders
- Market Order Protection
- Regulation NMS

Referenced Rules & Notices

- NASD IM-2110-2
- NASD Rule 2111
- NTM 07-19

Background and Discussion

IM-2110-2 (referred to as the "Manning Rule") generally prohibits a member firm 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.[2] The legal underpinnings for the Manning Rule are a member firm's basic fiduciary obligations and the requirement that a firm must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade." The same principles on which the Manning Rule is based apply to the treatment of customer market orders pursuant to Rule 2111, which generally prohibits a member that accepts and holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order.

On May 6, 2008, the SEC approved amendments to IM-2110-2 and Rule 2111 that establish a new exemption relating to ISOs. As amended, the requirements in IM-2110-2 and Rule 2111 do not apply to trading for a member firm's own account that is the result of an ISO routed in compliance with Rule 600(b)(30)(ii) of Regulation NMS where the customer order is received **after** the member routed the ISO.[3] The intent of the exemption is to facilitate member firm compliance with Rule 611 of Regulation NMS without compromising important limit and market order protection requirements. The exemption, therefore, is based on the assumption that the turnaround time from when an ISO is sent out to execute against the full displayed size of a protected quote and the response time to the sender is extremely short, generally because such orders are marked with a time-in-force of Immediate-or-Cancel (IOC). Accordingly, to the extent that a member firm may route an ISO order with a time-in-force greater than IOC, any portion of the member firm's order that is not executed immediately would no longer fall within the terms of the exemption, and any subsequent executions must comport with the obligations under IM-2110-2 and Rule 2111.

Also as amended, the requirements in IM-2110-2 and Rule 2111 do not apply to trading for a member firm's own account that is the result of an ISO where the member firm executes the ISO to facilitate a customer order and that customer has consented to not receiving the better prices obtained by the ISO. In this regard, the exemption applies only to the consenting customer's order and does not allow the member firm to trade ahead of any other unexecuted customer orders that were received by the firm prior to the time that the firm routed the relevant ISO order.

The amendments became effective on May 6, 2008, the SEC approval date.

Endnotes

1 *See* Securities Exchange Act Release No. 57784 (May 6, 2008), 73 FR 27587 (May 13, 2008) (order approving SR-FINRA-2007-039).

2 The SEC approved changes to IM-2110-2 that, among other things, expand its scope to OTC equity securities. *See* Securities Exchange Act Release No. 55351 (February 26, 2007), 72 FR 9810 (March 5, 2007) (order approving SR-NASD-2005-146). *See also NASD Notice to Members 07-19* (April 2007). *See also* File Nos. SR-FINRA-2007-038, SR-FINRA-2007-023, SR-NASD-2007-041 and SR-NASD-2007-039.

3 Rule 600(b)(30) of Regulation NMS defines an ISO as a limit order for an NMS stock that meets the following requirements: (i) when routed to a trading center, the limit order is identified as an ISO; and (ii) simultaneously with the routing of the limit order identified as an ISO, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the NMS stock with a price that is superior to the limit price of the limit order identified as an ISO. These additional routed orders also must be marked as ISOs.

Attachment A

Below is the text of the rule changes. New language is underlined.

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

(a) through (c) No change.

(d) Intermarket Sweep Order Exemption

A member shall be exempt from the obligation to execute a customer limit order in a manner consistent with this interpretation with regard to trading for its own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of Regulation NMS ("ISO") where the customer limit order is received after the member routed the ISO. A member also shall be exempt with respect to trading for its own account that is the result of an ISO where the member executes the ISO to facilitate a customer limit order and that customer has consented to not receiving the better prices obtained by the ISO.

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2111. Trading Ahead of Customer Market Orders

(a) through (f) No change.

(g) The obligations under this rule shall not apply to trading for a member's own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of Regulation NMS ("ISO") where the customer market order is received after the member routed the ISO. The obligations under this rule also shall not apply with respect to trading for a member's own account that is the result of an ISO where the member executes the ISO to facilitate a customer market order and that customer has consented to not receiving the better prices obtained by the ISO.

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