

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50097; File No. SR-NASD-2004-112)

July 27, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Extend Its Pilot Program Relating to Price-Improvement Standards under the Manning Interpretation

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 23, 2004, 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 and II 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 and to approve the proposal, on an accelerated basis. This accelerated approval extends the pilot program retroactively to July 1, 2004, and prospectively through December 31, 2004.

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

NASD proposes to extend retroactively to July 1, 2004, and prospectively through December 31, 2004, the current pilot program relating to price-improvement standards for decimalized securities contained in NASD IM-2110-2 - Trading Ahead of Customer Limit Order (“Manning Interpretation”). Without such an extension, these standards would expire on June 30, 2004. NASD does not propose to make any substantive changes to the pilot; NASD is proposing only to make the pilot rule effective on a retroactive basis to July 1, 2004, and to extend the pilot’s expiration date to December 31, 2004.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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 proposal. The text of these statements may be examined at the places specified in Item III 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

NASD's Manning Interpretation, among other things, requires an NASD member firm to provide a minimum level of price improvement to an incoming order in an NMS or SmallCap security if the firm chooses to trade as principal with the incoming order at a price superior to that of the customer limit order that the firm currently holds. If the firm fails to provide the minimum level of price improvement to the incoming order, the firm must execute the held customer limit order. Generally, if the firm fails to provide the requisite amount of price improvement and also fails to execute the held customer limit order, it is in violation of the Manning Interpretation.

On April 6, 2001, the Commission approved, on a pilot basis, price-improvement standards in the Manning Interpretation for trading in a decimalized environment.<sup>3</sup> That proposal added the following language to IM-2110-2:

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<sup>3</sup> See Securities Exchange Act Release No. 44165 (April 6, 2001), 66 FR 19268 (April 13, 2001) ("Pilot Approval Order").

For Nasdaq securities authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, and not be required to execute the held limit order, 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 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).<sup>4</sup>

Since approval, these standards have operated on a pilot basis, which would terminate on June 30, 2004.<sup>5</sup> After consultation with SEC staff, NASD has determined to seek an extension of its current pilot until December 31, 2004. NASD also is seeking to make this proposal effective on a retroactive basis to July 1, 2004. NASD believes that such an extension provides for an appropriate continuation of the current Manning price-improvement standard while the Commission continues to analyze the issues related to customer limit order protection in a decimalized environment. NASD is not proposing any substantive changes to the pilot at this time.

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<sup>4</sup> Pursuant to the terms of the Decimals Implementation Plan for the Equities and Options Markets, the minimum quotation increment for Nasdaq securities (both NMS and SmallCap) at the outset of decimal pricing is \$0.01. As such, Nasdaq displays priced quotations to two places beyond the decimal point (to the penny). Quotations submitted to Nasdaq that do not meet this standard are rejected by Nasdaq systems. See Securities Exchange Act Release No. 43876 (January 23, 2001), 66 FR 8251 (January 30, 2001) (SR-NASD-2001-07).

<sup>5</sup> See Securities Exchange Act Release No. 48876 (December 4, 2003), 68 FR 69103 (December 11, 2003) (extending pilot price-improvement standard to June 30, 2004).

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>6</sup> which requires, among other things, that NASD's 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 would continue the current pilot program's protection of customer limit orders and promote the integrity of the market.

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

NASD does not believe that the proposed rule change would 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

Written comments were neither solicited nor received.

## III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the proposed rule change, 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](mailto:rule-comments@sec.gov). Please include SR-NASD-2004-112 on the subject line.

### Paper comments:

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<sup>6</sup> 15 U.S.C. 78o-3(b)(6).

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to SR-NASD-2004-112. 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 Section, 450 Fifth Street, NW, 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 SR-NASD-2004-112 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

#### IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>7</sup> In particular, the Commission finds that the proposed rule

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<sup>7</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

change is consistent with Section 15A(b)(6) of the Act<sup>8</sup> because it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission previously has found NASD's pilot rule relating to price-improvement standards under the Manning Interpretation to be consistent with the Act.<sup>9</sup> NASD now proposes to reinstate the pilot; to make it effective retroactively to July 1, 2004; and extend it through December 31, 2004. NASD is not proposing any textual changes to the pilot rule. In the Pilot Approval Order, the Commission stated that the pilot rule should ensure that customer limit orders "will continue to have access to market liquidity ahead of market makers in appropriate circumstances."<sup>10</sup> More recently, the Commission also has stated:

When market participants can gain execution priority for an infinitesimally small amount, important customer protection rules such as exchange priority rules and the NASD's Manning Interpretation as currently formulated could be rendered meaningless. . . . If investors' limit orders lose execution priority for a nominal amount, over time, investors may cease to use them, which would deprive the markets of a vital source of liquidity.<sup>11</sup>

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<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

<sup>9</sup> See supra note 3.

<sup>10</sup> 66 FR at 19271.

<sup>11</sup> Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126, 11170 (March 9, 2004) (proposing Regulation NMS). Nothing in this approval order presupposes any action that the Commission may take with respect to proposed Regulation NMS.

For these reasons, the Commission continues to believe that NASD's pilot rule is consistent with the Act and will continue to provide beneficial protection to customer limit orders.

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after publication of notice of filing thereof in the Federal Register. Accelerated approval will allow the customer limit order protection offered by the pilot rule to continue without interruption.

**V. Conclusion**

IS IT THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (SR-NASD-2004-112) is hereby approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).