

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59138; File No. SR-FINRA-2008-064)

December 22, 2008

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Proposed Rule Change to Amend NASD Interpretive Material (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 December 17, 2008, 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”) the proposed rule change 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 NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order) to provide that, for the purpose of determining the minimum price improvement obligation where there is no published current inside spread, members may calculate a current inside spread by contacting and obtaining priced quotations from at least two unaffiliated dealers.

The text of the proposed rule change is attached as Exhibit 5.³

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Commission notes that Exhibit 5 is attached to the rule filing filed with the Commission but not to this release. The text of the proposed rule change is available at FINRA, on its Web site (www.finra.org), and at the Commission’s Public Reference Room.

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

NASD IM-2110-2 (commonly referred to as the "Manning Rule") generally prohibits a member from trading for its own account at prices that would satisfy a customer's limit order unless the member immediately thereafter executes the customer limit order at the price at which it traded for its own account or at a better price. The legal underpinnings for IM-2110-2 are a firm's basic fiduciary obligations under agency law 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."

On September 12, 2008, the SEC approved amendments to the minimum price-improvement standards in IM-2110-2 to provide tiered standards that vary according to the price

of the customer limit order.⁴ The amendments became effective on November 11, 2008.⁵ Revised NASD IM-2110-2 prescribes detailed minimum levels of price improvement that a member must provide in order to trade ahead of an unexecuted customer limit order without triggering the protection's provided by the rule. In other words, the price-improvement standards in IM-2110-2 set forth the minimum amount by which a member must trade, in addition to the price of the customer buy limit order (or less than the price of a customer sell order), to avoid triggering the protections provided by IM-2110-2.

The minimum price improvement tiers are 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;

⁴ See Securities Exchange Act Release No. 58532 (September 12, 2008), 73 FR 54649 (September 22, 2008) (order approving SR-NASD-2007-041).

- 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.

Therefore, if a firm is holding a customer limit order to buy priced at \$.75 and the applicable minimum price improvement standard is \$.01, the firm would be permitted to buy at \$.76 or higher without triggering the requirements of IM-2110-2.

The proposed rule change is being filed to provide members with an alternative method of calculating the minimum price improvement in cases where a member receives a limit order priced to sell an OTC equity security below \$1.00 and there is no quoted market. The minimum price-improvement standards are either a fixed amount or one-half (1/2) of the current inside spread. However, where there is no current inside spread, the minimum price-improvement standard defaults to the fixed amount which, in certain circumstances, can equal the price of the customer limit order. For example, where a member receives a customer limit order priced at \$.01 and there is no current published inside spread, the minimum price-improvement standard would still be equal to \$.01, which would require the member to sell at 0 (\$.01 minus \$.01) to

⁵ See Regulatory Notice 08-49 (September 2008).

avoid triggering the customer limit order. Thus, under the current rule, the member is effectively prohibited from selling while the customer limit order is pending. FINRA believes that this result is overly restrictive.

Thus FINRA is proposing to amend IM-2110-2 to provide that, for the purpose of determining the minimum price improvement obligation where there is no published current inside spread, member firms may calculate a current inside spread by contacting and obtaining priced quotations from at least two unaffiliated dealers. FINRA believes that obtaining priced quotations from a minimum of two unaffiliated dealers provides an adequate proxy for an inside spread typically displayed for an OTC equity security, but members are free to contact more than two unaffiliated dealers. Once the member has obtained bid and ask prices from at least two unaffiliated dealers, the highest bid and lowest offer obtained must be used as the basis for calculating the current inside spread for purposes of determining the member's minimum price improvement obligation.

Additionally, where there is a one-sided quote, the proposed rule change would permit a member to determine the current inside spread by using the best price obtained from at least two unaffiliated dealers on the other side of the quote. Members must document (1) the name of each dealer contacted and (2) the quotations received that were used as the basis for determining the current inside spread. The proposed rule change would apply solely to minimum price-improvement calculations under IM-2110-2 and would not implicate other rules or requirements (e.g., Three Quote Rule).

The proposed rule change would address the unintended effective prohibition on selling while certain customer limit orders are pending by providing members with an alternative means

of determining the inside spread for use as the basis for calculating its minimum price-improvement obligation.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁶ 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 will address an unintended consequence of the minimum price-improvement standards set forth in IM-2110-2 while continuing to promote investor protection and improving the treatment of customer limit orders.

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

Written comments were neither solicited nor received.

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 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

⁶ 15 U.S.C. 78q-3(b)(6).

(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-FINRA-2008-064 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-FINRA-2008-064. 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, on official business days between the hours of 10:00 a.m. and 3:00

p.m. Copies of the 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-FINRA-2008-064 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁷

Florence E. Harmon
Acting Secretary

⁷ 17 CFR 200.30-3(a)(12).