

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58114; File No. SR-NASD-2007-041)

July 7, 2008

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc. (f/k/a National Association of Securities Dealers, Inc.); Notice of Filing of Amendment No. 2 to Proposed Rule Change to Amend the Minimum Price-Improvement Standards Set Forth in NASD Interpretive Material (IM) 2110-2

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 June 26, 2008, the Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”))³ 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 substantially prepared by FINRA.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 2, from interested parties.

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

FINRA proposes to amend the proposed rule change to address an inconsistency in the application of the proposed minimum price-improvements standards. The text of

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On July 26, 2007, the Commission approved a proposed rule change filed by the NASD to amend the NASD’s Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007) (SR-NASD-2007-053).

⁴ FINRA filed the original proposed rule change on June 27, 2007. FINRA filed Amendment No. 1 to the proposed rule change on May 20, 2008. Amendment No. 2 supersedes and replaces Amendment No. 1.

the proposed rule change is available on FINRA's Web site (www.finra.org), at FINRA's principal office, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of the Proposed Rule Change

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

1. Purpose

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 Commission published for comment the proposed rule change in the Federal Register.⁵ The Commission received one commenter letter on the proposed rule change.⁶ On November 1, 2007, FINRA submitted a response letter to the Commission.⁷ On May 20, 2008, FINRA filed with the Commission Amendment No. 1 to the proposed rule change. FINRA is filing this Amendment No. 2, which replaces and supersedes 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 improvement standards as discussed herein.

On February 26, 2007, the Commission approved SR-NASD-2005-146, which, among other things, expanded the scope of IM-2110-2⁸ to apply to over-the-counter

⁵ See Securities Exchange Act Release No. 56297 (August 21, 2007), 72 FR 49337 (August 28, 2007) (notice of filing of SR-NASD-2007-041).

⁶ See Letter to Secretary, Commission, from Jess Haberman, Compliance Director, Fidessa Corp., dated September 5, 2007.

⁷ See Letter from Andrea Orr, FINRA, to Nancy M. Morris, Secretary, Commission, dated November 1, 2007 ("FINRA Response Letter").

⁸ 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

(“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, 2007.⁹

Following Commission approval of SR-NASD-2005-146, several firms raised concerns regarding the timing of the implementation of the proposed 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.¹⁰

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.¹¹

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.

⁹ See NASD Notice to Members 07-19 (April 2007).

¹⁰ 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).

¹¹ See supra note 6.

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 obligation under IM-2110-2 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 Interpretive Material, 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.

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,¹² which requires, among other things, that FINRA rules 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. 2.¹³

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

¹² 15 U.S.C. 78o-3(b)(6).

¹³ See supra note 6.

(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, as modified by Amendment No. 2, 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 No. 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, 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 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 Trading and Markets, pursuant to delegated authority.¹⁴

Florence E. Harmon
Acting Secretary

¹⁴ 17 CFR 200.30-3(a)(12).