

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51230; File No. SR-NASD-2004-045)

February 18, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Adopt NASD Rule 2111 to Prohibit Members from Trading Ahead of Customer Market Orders

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 March 12, 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, II, and III below, which Items have been prepared by NASD. On February 16, 2005, NASD amended the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.⁴

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

NASD is proposing to prohibit members from trading ahead of a customer market order under the circumstances described herein. Below is the text of the proposed rule change. Proposed new language is in italics.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Amendment No. 1 to SR-NASD-2004-045 filed on February 16, 2005. Amendment No. 1 made clarifying changes to the proposed rule text

⁴ NASD notes that related to this proposed rule filing it has also filed SR-NASD-2004-026, a proposed rule change that would amend NASD Rule 2320(a), known as the “Best Execution Rule.” See Securities Exchange Act Release No. 51229 (February 18, 2005)(SR-NASD-2004-026). NASD has also filed SR-NASD-2004-089, a proposed rule change that would provide price improvement to customer limit orders under certain circumstances. See Securities Exchange Act Release No. 51231 (February 18, 2005)(SR-NASD-2004-089).

2111. Trading Ahead of Customer Market Orders

(a) A member must make every effort to execute a customer market order that it receives fully and promptly.

(b) A member that accepts and holds a market order of its own customer or a customer of another broker-dealer in a Nasdaq or exchange-listed security without immediately executing the order is prohibited from trading that security on the same side of the market for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or at a better price.

(c) A member that is holding a customer market order that has not been immediately executed must make every effort to cross such order with any market order, marketable limit order, or non-marketable limit order priced better than the best bid or offer, received by the member on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent market order, marketable limit order or non-marketable limit order is received by the member and that is consistent with the terms of the orders. In the event that a member is holding multiple orders on both sides of the market that have not been executed, the member must make every effort to cross or otherwise execute such orders in a manner that is reasonable, and is consistent with the objectives of this rule and with the terms of the orders. The member must have a written methodology in place governing the execution and priority of all such pending orders and must ensure that such methodology is consistently applied.

(d) A member may negotiate specific terms and conditions applicable to the acceptance of a market order only with respect to market orders that are: (1) for customer accounts that meet the definition of an “institutional account” as that term is defined in Rule 3110(c)(4), or (2) 10,000 shares or more, unless such orders are less than \$100,000 in value.

(e) This rule applies to limit orders that are marketable at the time they are received by the member or become marketable at a later time. Such limit orders shall be treated as market orders for purposes of this rule, however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit order must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or Rule 6440(f)(2), as applicable.

(f) The obligations under this rule shall not apply to a member’s proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the “facilitated order”), provided that all of the following requirements are satisfied:

(1) The handling and execution of the facilitated order must satisfy the definition of a “riskless” principal transaction, as that term is defined in NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), 4652(d)(3)(B), 4632A(e)(1)(C) or 6420(d)(3)(B);

(2) A member that relies on this exclusion to the rule must give the facilitated order the same per-share price at which the member accumulated or sold shares to

satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee;

(3) A member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) and 4632A(e)(1)(C)(ii), or a substantially similar report to another trade reporting system; and

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with applicable NASD rules. At a minimum these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner all orders on which a member relies in claiming this exception.

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

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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 proposed rule change. The text of these statements may be examined at

the places specified in Item IV 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

Background

NASD Interpretive Material 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule") generally prohibits members from trading for their own account at prices that would satisfy a customer's limit order, unless the member immediately thereafter executes the customer limit order.⁵ The legal underpinnings for the Manning Rule are a member's basic fiduciary obligations 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."⁶

NASD believes that the same principles on which the Manning Rule is based should apply to the treatment of customer market orders. As such, on March 12, 2004, NASD filed the instant proposed rule change, proposing amendments to require market order protection. The proposed rule change sought to adopt new NASD Rule 2111 that would prohibit a member from trading ahead of a customer market order under the circumstances described therein. NASD proposed certain changes to proposed NASD Rule 2111 with Amendment No. 1.

⁵ For example, if the member bought 100 shares at \$10 when holding customer limit orders in the same security to buy at \$10 equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders. NASD Rule 6440(f)(2) imposes similar requirements with respect to the receipt of customer limit orders in exchange-listed securities.

⁶ See NASD Rule 2110.

Proposal

NASD is proposing that a member be prohibited from trading for its proprietary account on the same side of the market as a customer market order, if that customer market order has not been executed fully and promptly. Specifically, the proposed rule change would prohibit a member from trading for its own account on the same side of the market as a customer market order in a Nasdaq or exchange-listed security⁷ if the member accepts and holds a customer market order in that security without immediately executing the order, unless such member immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or a better price.⁸ Similar to the application of the Manning Rule, customer market orders would include orders received from the member's own customers or customer orders of another broker-dealer. In addition, if a member is holding a customer market order that has not been immediately executed, such member would be required to make every effort to match the pending market order against any market orders, marketable limit orders or

⁷ NASD Rule 6440(f)(1) currently prohibits a member from personally buying (selling) an exchange-listed security for its own account while such member holds an unexecuted market order to buy (sell) such security for a customer. The proposed rule change would prohibit a broad range of conduct, including conduct prohibited by NASD Rule 6440(f)(1) and therefore, NASD staff will recommend to Nasdaq that it consider deleting NASD Rule 6440(f)(1), in light of the proposal described herein.

⁸ The agency obligation of a broker-dealer with respect to a customer order is defined by the customer's expectation of the treatment of the order. A customer's market order generally represents the expectation that the order will be executed fully and promptly at the current best bid, for a sell order, or best offer, for a buy order, regardless of the impact on market price. In attempting to meet this expectation, there is some reasonable period of time in which market orders may queue while the broker-dealer is executing orders ahead on both sides of the market. This proposed rule change represents NASD's view that, when that reasonable time period has expired, the member shall not be permitted to trade that security for its own account on the same side of the market as its customer market order without giving the customer market order an execution at that same price or better.

non-marketable limit orders priced better than the best bid or offer received by the member on the other side of the market up to the size of the pending market order and at a price that is no less than the best bid and no greater than the best offer at the time such subsequent market order, marketable limit order or non-marketable limit order is received by such member and is consistent with the terms of the pending order.

In the event that a member is holding multiple orders on both sides of the market that have not been executed, the member must make every effort to cross or otherwise execute such orders in a manner that is reasonable and is consistent with the objectives of the proposed rule change and with the terms of the orders. The member also must have a written methodology in place governing the execution priority of all such pending orders and must ensure that such methodology is consistently applied.

For example, assume the inside market for security ABCD is 10 to 10.05 and Firm A receives a market order to buy 1,000 shares of ABCD from Customer C1, which Firm A has not immediately executed. If Firm A buys 1,000 shares of ABCD at 10 from Firm B (or from any other source), Firm A would be required to sell 1,000 shares of ABCD to C1 at 10 or better. Similarly, if Firm A bought shares for its own account below the best bid of 10, it would be required to sell stock to C1 at that same price below the bid or better.

If a member does not execute an order fully and promptly, but has not bought or sold securities for its own account on the same side of the market as the customer order or has not received a market order, marketable limit order or non-marketable limit order priced better than the best bid or offer from another customer on the contra-side of the market, the proposed rule change would not impose any specific obligations on the

member above and beyond the member's current obligations to market orders, such as a member's best execution requirements under NASD Rule 2320.⁹

The proposed rule change also would incorporate several of the same types of exclusions that apply to the Manning Rule. First, the proposed rule change would permit members to negotiate specific terms and conditions applicable to the acceptance of a market order with respect to a market order for customer accounts that meet the definition of an "institutional account" as that term is defined in NASD Rule 3110(c)(4) or a market order that is for 10,000 shares or more, unless such order is less than \$100,000 in value.

Second, the proposal would provide an exception for member proprietary trades that are part of an execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another member) (the "facilitated order"). This exclusion would apply only if the following requirements are met: (1) the handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules; (2) the member must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee; (3) a member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii), 4652(d)(3)(B)(ii), 6420(d)(3)(B)(ii) or 4632A(e)(1)(C)(ii), or a substantially similar report; and (4) members must have written policies and procedures to assure that riskless principal transactions relied upon for this exclusion comply with

⁹ See NASD Rule 2320(a) (the "Best Execution Rule"). NASD has proposed changes to the Best Execution Rule in SR-NASD-2004-026 (February 12, 2004), See footnote 4, supra.

applicable NASD rules.¹⁰

For example, assume that the inside market for security ABCD is 10 to 10.05 and Firm A receives a market order to buy 1,000 shares of ABCD from Customer C1 and immediately thereafter, receives a market order to buy 500 shares of ABCD from Customer C2. Firm A has not immediately executed the orders from C1 and C2. If Firm A purchases 1,000 shares at 10 to fill C1's order on a riskless principal basis and otherwise meets the requirements of the riskless principal exception to the proposed rule change, the riskless principal trade would not trigger an execution of C2's order under the proposed rule change. Under the same facts noted above, alternatively if Firm A were to execute C2's order for 500 shares on a riskless principal basis prior to executing C1's order, the riskless principal trade would not trigger the execution (or partial execution) of C1's order.¹¹

¹⁰ With respect to requirement (4), the member's policies and procedures, at a minimum, must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD to reconstruct accurately, readily, and in a time-sequenced manner, all orders on which a member relies in claiming this exemption.

¹¹ Except as specifically provided in the proposed rule change, NASD has not mandated any particular order handling and execution priority procedures among market orders. Thus, a member may choose any reasonable methodology for the way in which it executes multiple orders that it holds, but the member must ensure that such methodology is applied consistently. For example, a member could use a first in first out (FIFO) methodology or some other objective methodology or formula. It would be inappropriate, however, for a member's methodology to give priority, for example, to orders of certain "preferred accounts" or preference institutional orders over retail orders. To the extent a member elects a specific methodology, the member must document that methodology and have written supervisory procedures and systems in place to ensure that the methodology it has chosen is consistent with the duty of best execution. Further, simply because a member employs a methodology for execution of orders and that methodology is followed in a particular circumstance does not automatically mean that any or all customer orders executed pursuant to such a methodology have received best execution under NASD Rule 2320.

The proposed rule change also applies to limit orders that are marketable at the time they are received by the member or that become marketable at a later time. Such limit orders would be treated as market orders for purposes of the proposed rule change; however, these orders must continue to be executed at their limit price or better. If a customer limit order is not marketable when received, the limit order must be provided the full protections of IM-2110-2 for Nasdaq securities of NASD Rule 6440(f)(2) for exchange-listed securities. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable, it must be provided the full protections of IM-2110-2 or NASD Rule 6440(f)(2).

The proposed rule change applies to NASD members irrespective of upon which market they trade. If a member were to execute a proprietary trade on an exchange while holding a customer market order on the same side of the market that the member has not fully and promptly executed, then the member would be deemed to have violated the proposed rule change unless (1) the member immediately provides an execution to that market order at a price equal to or better than the proprietary trade; or (2) the member's proprietary trade was in accordance with a functional role, recognized within the rules of that exchange, of acting as a liquidity provider, such as acting in the role of a specialist or some other substantially similar capacity.

NASD is emphasizing that nothing in the proposed rule change modifies the application of NASD Rule 2320 with respect to a member's obligations to customer orders. For example, to the extent a member does not execute a market order fully and promptly, compliance with the proposed rule change would not safeguard the member from potential liability due to non-compliance with its best execution responsibilities.

Finally, in recognition that the proposed rule change may alter the way that many members handle customer orders, NASD believes it is important to provide members with adequate time to develop and implement systems to comply with the proposed rule change. Therefore, should the Commission approve the proposed rule change NASD is proposing an implementation date of 90 days after the issuance of a Notice to Members announcing SEC approval of the proposed rule change.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,¹² in general, and with Section 15A(b)(6) of the Act,¹³ in particular, which requires that NASD 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. NASD believes that the proposed rule change will improve the treatment of market orders and enhance the integrity of the market.

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

NASD 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, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited or received.

¹² 15 U.S.C. 78o-3.

¹³ 15 U.S.C. 78o-3(b)(6).

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
- 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 amended, 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-NASD-2004-045 on the subject line.

Paper Comments:

- 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 File Number SR-NASD-2004-045. 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. Copies of such filing also will be available for inspection and copying at the principal office of the 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 File Number SR-NASD-2004-045 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Margaret H. McFarland
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).