Notice to Members

OCTOBER 2005

SUGGESTED ROUTING

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Legal & Compliance
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KEY TOPICS

IM-2110-2
Manning Rule
Market Orders
Rule 2111

GUIDANCE

Market Order Protection

SEC Approves New Rule 2111 Prohibiting Members from Trading Ahead of Customer Market Orders Under Certain Circumstances; **Effective Date: January 9, 2006**

Executive Summary

On August 9, 2005, the Securities and Exchange Commission (SEC) approved new Rule 2111, Trading Ahead of Customer Market Orders, which prohibits a firm 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.[1] Rule 2111, as adopted, is set forth in Attachment A of this *Notice*. NASD will be publishing shortly, in a separate *Notice*, questions and answers regarding the application of the new rule. The rule becomes effective on January 9, 2006.

Questions/Further Information

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

Background and Discussion

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. 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

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equitable principles of trade."[2] NASD believes that the same principles on which the Manning Rule is based should apply to the treatment of customer market orders. As such, NASD proposed, and the SEC approved, new Rule 2111, which prohibits members from trading ahead of market orders under certain circumstances.

Specifically, Rule 2111 prohibits a member that accepts and holds a customer market order from trading for its own account on the same side of the market as the customer market order at prices that would satisfy the customer's order, unless it immediately thereafter executes the customer market order up to the size and at the same price or better at which it traded for its own account. Similar to the application of the Manning Rule, customer market orders would include orders received from the member's own customers or customer orders received from another broker-dealer.

In addition, if a member is holding a customer market order that has not been immediately executed, Rule 2111 requires that the member make every effort to match the pending market order against any market orders, marketable limit orders or non-marketable limit orders priced better than the best bid or offer, received by the member on the other side of the market. Such orders must be executed at a price that is no less than the best bid, no greater than the best offer at the time the subsequent order is received by the member, and consistent with the terms of the pending market 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 rule and with the terms of the orders.[3] Members must have a written methodology in place governing the execution priority of all such pending orders, whether the member is holding one order or multiple orders on both sides of the market, and must ensure that such methodology is consistently applied.

Rule 2111 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. Once marketable, such limit orders are treated as market orders for purposes Rule 2111; 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 the Manning Rule, 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 Manning Rule.

Rule 2111 applies to NASD members irrespective of the market or market center upon which they trade. As such, 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, the member will be deemed to have violated Rule 2111 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.

Rule 2111 also incorporates several of the same types of exclusions that apply to the Manning Rule. First, Rule 2111 permits 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 Rule 3110(c)(4)[4] or a market order that is for 10,000 shares or more, unless such order is less than $100,000 in value.

Second, Rule 2111 provides 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 applies 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 applicable NASD rules.[5]

NASD is emphasizing that nothing in Rule 2111 modifies the application of 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 Rule 2111 would not safeguard the member from potential liability due to non-compliance with its best execution responsibilities.

In recognition that the new rule may alter the way that many members handle customer orders, NASD is providing 90 days from this *Notice* for implementation to provide members with adequate time to develop and implement systems to comply with the new rule. As such, Rule 2111 becomes effective January 9, 2006.

Endnotes

1 *See Securities Exchange Act Release No. 52226* (August 9, 2005), 70 FR 48219 (August 16, 2005) (File No. SR-NASD-2004-045).

2 *See* NASD Rule 2110.

3 A member holding a customer market order that has not been immediately executed or a member holding multiple orders on both sides of the market may satisfy the crossing requirements under the rule by contemporaneously buying from the seller and selling to the buyer at the same price.

4 Rule 3110(c)(4) defines "institutional account" to mean the account of a bank, savings and loan, insurance company, registered investment company, registered investment adviser or the account of any other entity with total assets of at least $50 million.

5 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 which a member relies in claiming this exemption.

ATTACHMENT A

New language is underlined.

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) (1) 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.

(2) 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.

(3) For purposes of this paragraph (c), a member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

(4) A member must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of this rule. A member also must ensure that this 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 broker-dealer) (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.