

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-45011; File No. SR-NASD-2001-78)

November 1, 2001

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Manning Pilot for Limit Order Protection on the OTC Bulletin Board

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 November 1, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq has designated the proposed rule change as constituting a "non-controversial" rule change under paragraph (f)(6) of Rule 19b-4 under the Act,³ which renders the proposal effective upon receipt of this filing by the Commission. 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

This is a proposal to amend NASD Rule 6541 which, for a pilot period ending February 8, 2002, prohibits member firms from trading ahead of customer limit orders in designated OTC Bulletin Board ("OTCBB") securities. Portions of NASD Rule 6541 were previously amended for a three-month pilot period running from August 1, 2001, to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR 240.19b-4(f)(6).

November 1, 2001.⁴ The amendment effected by this filing revises the rule text of the three-month pilot.

Pursuant to Rule 19b-4(f) under the Act, Nasdaq has designated this proposal as non-controversial and requests that the Commission waive both the five-day notice and the 30-day pre-operative requirement contained in Rule 19b-4(f)(6)(iii).⁵ If such waiver is granted by the Commission, the rule change will be effective on November 1, 2001, and will remain in effect for a pilot period ending on January 14, 2002, the date when a similar pilot rule relating to Nasdaq securities will expire.

The text of the proposed rule change is provided below. New language is in italics; deletions are in brackets.

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6541. Limit Order Protection

(a) Members shall be prohibited from "trading ahead" of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.

(b) Members may [not] avoid [such] the obligation specified in paragraph (a) through the provision of price improvement[, unless:]. If a customer limit order is priced at or inside the current inside spread, however, the price improvement must be for a

⁴ See Securities Exchange Act Release No. 44593 (July 26, 2001), 66 FR 40304 (August 2, 2001).

⁵ 17 CFR 240.19b-4(f)(6)(iii).

minimum of the lesser of \$0.01 or one-half (1/2) of the current inside spread.

[(1) for customer limit orders priced at or inside the current inside spread, the price improvement is for a minimum of the lesser of \$.01 or one-half (1/2) of the current inside spread; or]

[(2) for customer limit orders priced outside the current inside spread by \$.01 or less, the market maker executes the incoming order at or better than the inside bid (for held buy orders) or offer (for held sell orders).]

[(3) for customer limit orders priced more than \$.01 outside the inside spread, no obligation is imposed under subsection (a) above.]

For purposes of this rule, the inside spread shall be defined as the difference between the best reasonably available bid and offer in the subject security.

(c) - (e) No Change.

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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, Nasdaq 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. Nasdaq 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

On February 8, 2001, the Commission approved new NASD Rule 6541 which, on a pilot basis, applies the basic customer limit order protection principles that presently

apply to Nasdaq securities to designated securities that are traded on the OTCBB.⁶ NASD Rule 6541(a), in general, prohibits member firms that accept customer limit orders in these securities from "trading ahead" of their customers for their own account at prices equal or superior to the limit orders, without executing them at the limit price. NASD Rule 6541(b) requires member firms to provide a minimum level of price improvement to incoming orders in OTCBB securities if the firm chooses to trade as principal with those incoming orders while holding customer limit orders. If a firm fails to provide the minimum level of price improvement to the incoming order, the firm must execute its held customer limit orders.

The limit order protection embodied in NASD Rule 6541 is an investor protection tool based on NASD IM-2110-2 (commonly known as the "Manning Rule"). In Manning, the NASD found and the SEC affirmed that a member firm that accepts a customer limit order has a fiduciary duty not to trade for its own account at prices more favorable than the customer order.⁷ NASD Rule 6541 expands to the trading of OTCBB the protections that NASD IM-2110-2 provides to the trading of Nasdaq National Market and SmallCap securities.

On March 2, 2001 and April 6, 2001, the Commission approved modifications to NASD IM-2110-2.⁸ In general, these modifications narrowed the amount of price

⁶ See Securities Exchange Act Release No. 43944 (February 8, 2001), 66 FR 10541 (February 15, 2001) (approving SR-NASD-00-22).

⁷ See In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887 (July 6, 1988) ("Manning").

⁸ See Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001) (approving SR-NASD-2001-09); Securities Exchange Act Release No. 44165 (April 6, 2001), 66 FR 19268 (April 13, 2001) (approving SR-NASD-2001-27). See also Securities Exchange Act Release No. 44529 (July 9, 2001), 66 FR 37082 (July 16, 2001) (SR-NASD-2001-43).

improvement required to avoid the obligation to fill a customer limit order, in recognition of the introduction of decimal pricing of Nasdaq securities. On July 26, 2001, Nasdaq filed and implemented an amendment to NASD Rule 6541(b) (SR-NASD-2001-39) that likewise narrowed the amount of required price improvement for trading of OTCBB securities.⁹ As originally drafted, NASD Rule 6541(b) required price improvement of at least the lesser of \$0.05 or one-half of the current inside spread. Under SR-NASD-2001-39, the price improvement requirement was narrowed to \$0.01 or one-half the inside spread (whichever is less) for a market maker wishing to trade in front of a held customer limit order that is priced at or inside the current inside spread for an OTCBB security. For a customer limit order priced less than \$0.01 outside the inside spread, however, SR-NASD-2001-39 required a market maker seeking to trade in front of such limit order to execute its trades at a price at least equal to the inside bid (with respect to a held customer limit order to buy) or inside offer (for a held order to sell). Moreover, SR-NASD-2001-39 provided that limit order protection would not apply to a customer limit order that was priced more than \$0.01 outside the current inside spread. The amendment to NASD Rule 6541(b) adopted by SR-NASD-2001-39 has been effective for a three-month pilot period that ends on November 1, 2001.

Nasdaq is amending NASD Rule 6541(b) to eliminate the minimum price improvement requirement for limit orders outside the inside spread. Accordingly, any degree of price improvement would relieve a market maker from the obligation to fill a limit order that is outside of the inside spread. However, Nasdaq is also eliminating the provision of the pilot that provided no limit order protection to customer limit orders that

⁹ See Securities Exchange Act Release No. 44593 (July 26, 2001), 66 FR 40304 (August 2, 2001).

are priced more than \$0.01 outside the current inside spread. Thus, the basic prohibition on trading ahead of a customer limit order at a price equal or superior to the limit order without filling the limit order would apply to all limit orders in OTCBB securities covered by NASD Rule 6541. The amount of required price improvement for limit orders priced inside the current inside spread would remain the lesser of \$0.01 or one-half of the current inside spread.

Nasdaq proposes to make this change because the degree of price improvement required under both the original rule and SR-NASD-2001-39 is quite large in comparison to the share price of many OTCBB securities. In contrast to Nasdaq securities, many OTCBB securities trade at prices of a few cents or less and may be quoted out to four decimal places.¹⁰ Accordingly, OTCBB market makers may be required to fill limit orders at prices that are quite divergent, in percentage terms, from the price of the order that was traded ahead. An example will illustrate the concern addressed by this rule change:

Market is \$0.0165 to \$0.0167.

MM receives and holds customer's limit order to buy priced at \$0.0065.

MM receives a sell order priced at \$0.0164 and immediately executes that order on a proprietary basis.

Under the current pilot, since MM held a limit order to buy priced within \$0.01 of the inside spread and bought on a proprietary basis at a price less than the inside bid, MM would be required to fill the customer's limit order. In this example, however, the price

¹⁰ In the draft notice provided to the Commission, Nasdaq incorrectly stated that OTCBB securities could be quoted to five decimal places. Telephone conversation between John Yetter, Assistant General Counsel, Nasdaq, and Michael Gaw, Special Counsel, Commission, on November 1, 2001.

of the proprietary trade is over 150% higher than the price of the limit order that MM must fill. Thus, the operation of the rule may significantly affect the profitability of market making in the low-priced and thinly traded securities that are traded on the OTCBB. Under the proposed rule change, MM would be required to fill the limit order only if its proprietary trade was at or below the price of the limit order.

Nasdaq believes that the proposed rule change draws an appropriate balance between providing effective limit order protection for customers who aggressively seek to participate in trading at the inside market while reducing the incidence of forced trading losses to market makers who, in meeting their firm quote and best execution obligations to other market participants, trade near customer limit orders priced outside the spread. In doing so, Nasdaq believes that the proposed rule change will help to promote the liquidity of the OTCBB by encouraging greater market maker participation in the market. Nasdaq represents that it and NASD Regulation will closely monitor the protection of customer limit orders and analyze and evaluate trading activity to determine if future changes to price improvement standard of NASD Rule 6541 are warranted.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act¹¹ in that it is designed to: (1) promote just and equitable principles of trade; (2) foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; (3) perfect the mechanism of a free and open market and a national market system; and (4) protect investors and the public interest.

¹¹ 15 U.S.C. 78o-3(b)(6).

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

Nasdaq 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The proposed rule change has been filed by Nasdaq as a non-controversial rule change pursuant to Rule 19b-4(f)(6) under the Act. Nasdaq represents that the foregoing proposed rule change: (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest; therefore, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹² and Rule 19b-4(f)(6) thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Nasdaq has requested that the Commission waive the 30-day pre-operative period required by Rule 19b-4(f)(6), which would allow the proposal to become operative on

¹² 15 U.S.C. 78s(b)(3)(A).

November 1, 2001. The Commission finds that granting this request is consistent with the protection of investors and the public interest, as price improvement standards under NASD Rule 6541 will remain in effect on an uninterrupted basis.¹³ The Commission finds, moreover, that it is consistent with the protection of investors and the public interest to allow Nasdaq to eliminate NASD Rule 6541(b)(3) as of November 1, 2001, as this provision withholds limit order protection from customer limit orders in OTCBB securities that are priced more than \$0.01 outside the current inside spread.

Rule 19b-4(f)(6) also requires the self-regulatory organization to give the Commission written notice of its intent to file a proposed rule change at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. Nasdaq has requested that the Commission waive this five-day period. For the same reasons that the Commission has determined to waive the 30-day pre-operative period, the Commission also waives the five-day notice period.

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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. 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

¹³ For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

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 will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2001-78 and should be submitted by [insert date 21 days from the date of publication].

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

Jonathan G. Katz
Secretary

¹⁴ 17 CFR 200.30-3(a)(12).