SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59382; File No. SR-FINRA-2008-064)

February 11, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Amend NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order)

I. Introduction

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 ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order) with respect to the determination of the minimum price improvement obligation in an OTC equity security priced below $1.00 where there is no published current inside spread or there is only a one-sided quote. The proposed rule change was published for comment in the Federal Register on December 31, 2008.[3] The Commission received no comment letters on the proposed rule change.

II. Description of the Proposed Rule Change

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

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 59138 (December 22, 2008), 73 FR 80482.

it traded for its own account or at a better price. Under amendments to IM-2110-2 that the Commission approved on September 12, 2008,[4] and that became effective on November 11, 2008,[5] IM-2110-2 sets forth the minimum level of price improvement, depending on the price of the customer limit order, that a member must provide in order to trade ahead of an unexecuted customer limit order without triggering the protections provided by the Manning Rule.

The minimum price improvement tiers set forth in IM-2110-2 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;

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

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

(5) For customer limit orders priced less than $.0001 but greater than or equal to $0.00001, the minimum amount of price improvement required is the lesser of $0.00001 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 $0.000001 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 intended to provide members with an alternative method of calculating the minimum price improvement in cases where a member receives a limit order for an OTC equity security priced below $1.00 and there is no quoted market. The minimum price-improvement standards are either a fixed amount as noted above or one-half (½) 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 lead to an anomalous result. 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 $.00 ($.01 minus $.01) or buy at $.02 ($.01 plus $.01) to avoid triggering the customer limit order (depending on whether the customer order is a buy or sell order). Therefore, the current rule could have unduly harsh results, particulary in cases where the price is near the edge of a tier and there is no quoted market.

Accordingly, FINRA proposes 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 at least two unaffiliated dealers provides an adequate proxy for an inside spread typically displayed for an OTC equity security, and notes that members are free to contact more than two unaffiliated dealers. FINRA also notes that, once the member has obtained bid and ask prices from at least two unaffiliated dealers, the proposed rule requires that 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. In addition, where there is a one-sided quote, the proposed rule change permits 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. FINRA represents that 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).

III. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[6] In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[7] 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.

The Commission believes that the proposed rule change provides a reasonable method of calculating the current inside spread under IM-2110-2 for OTC equity securities priced below $1.00 where there is no current published inside spread or there is only a one-sided quote. The Commission notes that FINRA members that use the proposed method of calculating the current inside spread are required to document the name of each dealer contacted and the quotations received for the purposes of determining the current inside spread. The Commission believes that the documentation requirement is important to allow proper oversight of calculating the current inside spread, when there is no current published inside spread, or there is only a one-sided quote, in an OTC equity security priced below $1.00.

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6 In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

7 15 U.S.C. 78o–3(b)(6).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[8] that the proposed rule change (SR-FINRA-2008-064) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[9]

Florence E. Harmon
Deputy Secretary

8 15 U.S.C. 78s(b)(2).

9 17 CFR 200.30-3(a)(12).