

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56297; File No. SR-NASD-2007-041)

August 21, 2007

Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Notice of Filing of Proposed Rule Change to Amend the Minimum Price-Improvement Standards Set Forth in NASD IM 2110-2, Trading Ahead of Customer Limit Order

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 27, 2007, the National Association of Securities Dealers, Inc. (“NASD”) (n/k/a Financial Industry Regulatory Authority, Inc.) 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 substantially prepared by FINRA.³ 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

FINRA proposes to amend the minimum price-improvement standards set forth in NASD Interpretive Material (“IM”) 2110-2, Trading Ahead of Customer Limit Order. The text of the proposed rule change is available on FINRA’s Web site (www.finra.org), at FINRA, and at the Commission’s Public Reference Room.

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 NASD to amend 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).

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

In its filing with the Commission, FINRA 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. FINRA 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 26, 2007, the Commission approved SR-NASD-2005-146,⁴ which expanded the scope of IM-2110-2⁵ to apply to over-the-counter ("OTC") equity securities.⁶ The amendments relating to OTC equity securities are scheduled to become effective on November 26, 2007.⁷ Among other changes, SR-NASD-2005-146 amended the minimum level of price-improvement that a member must provide to trade ahead of an unexecuted customer limit order ("price-improvement standards") as follows. For customer limit orders priced greater than or equal to \$1.00 that are at or inside the best inside market, the minimum amount of price improvement required is \$0.01. For customer limit orders priced less than \$1.00 that are at or inside the best

⁴ See Securities Exchange Act Release No. 55351 (February 26, 2007), 72 FR 9810 (March 5, 2007) (order approving SR-NASD-2005-146).

⁵ 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 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.

⁶ See NASD Rule 6610(d) for definition of "OTC equity security."

⁷ See Securities Exchange Act Release No. 56103 (July 19, 2007), 72 FR 40918 (July 25, 2007) (SR-NASD-2007-039).

inside market, the minimum amount of price improvement required is the lesser of \$0.01 or one-half (1/2) of the current inside spread. For customer limit orders priced outside the best inside market, the member is required to execute the incoming order at a price at or inside the best inside market for the security. Lastly, for customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required is \$0.01.

For example, if the best inside market for a security is \$10 to \$10.05 and a member is holding a customer limit order to buy priced at \$10.01, the member would be permitted to buy at \$10.02 or higher, without triggering the customer limit order. If the best inside market for a security is \$.50 to \$.51 and the member is holding a customer limit order to buy priced at \$.50, the member would be permitted to buy at \$.505 ($$.50 + \frac{1}{2} ($.51 - $.50)$) or higher, without triggering the customer limit order.

FINRA is proposing to revise the minimum price improvement standards to address three issues. First, because the minimum price improvement standard is determined based on the lesser of a specified amount (\$.01) or 1/2 of the inside spread, the specified amount acts as an ‘upper limit’ on the minimum price improvement requirement. FINRA is concerned that the specified amount or upper limits on the minimum price improvement requirement (i.e., \$.01) is disproportionately high for securities trading below \$.01 and should vary proportionately with the amount of the limit order price. To address this inconsistency, FINRA is proposing to add the following maximum upper limits for each price level: 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. 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. For

customer limit orders priced less than \$.0001 but greater than or equal to \$.00001, the minimum amount of price improvement required is the lesser of \$.00001 or one-half (1/2) of the current inside spread.⁸ Lastly, for customer limit orders priced less than \$.00001, the minimum amount of price improvement required is the lesser of \$.000001 or one-half (1/2) of the current inside spread.⁹ FINRA believes these proposed requirements are better aligned with the value of the limit order and continue to require an appropriate amount of minimum price improvement over a customer limit order before a member can trade for its own account.

Second, the current minimum price improvement standard for limit orders priced over \$1.00 is \$.01 and applies uniformly to NMS stocks¹⁰ and OTC equity securities. However, given that subpenny quoting and trading is permissible in OTC equity securities priced over \$1.00 (and therefore subpenny spreads are possible), FINRA believes that the minimum price improvement standard should be adjusted to also include a measure based on the inside spread, consistent with the standards below \$1.00. Accordingly, FINRA is proposing that for customer limit orders in

⁸ The proposed minimum price-improvement provisions in this proposed rule change do not supersede, alter or otherwise affect any of the minimum pricing increment restrictions under Rule 612 of Regulation NMS. Rule 612 of Regulation NMS prohibits market participants from displaying, ranking, or accepting bids or offers, orders, or indications of interest in any NMS stock priced in an increment smaller than \$0.01 if the bid or offer, order, or indication of interest is priced equal to or greater than \$1.00 per share. If the bid or offer, order, or indication of interest in any NMS stock is priced less than \$1.00 per share, the minimum pricing increment is \$0.0001. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (File No. S7-10-04) (Regulation NMS Adopting Release).

⁹ For customer limit orders in securities for which there is no published inside market, the minimum amount of price improvement required would default to the same tiered minimum price improvement standards described herein. FINRA believes that the minimum price improvement requirement of \$.01 for customer limit orders in securities for which there is no published inside market is disproportionately high for lower-priced securities and, therefore, the proposed tiered requirements are more appropriate.

¹⁰ See Rule 600(b)(47) of Regulation NMS for definition of “NMS stock.” 17 CFR 242.600(b)(47).

OTC equity securities priced greater than or equal to \$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.¹¹

Finally, FINRA is proposing to change the minimum price improvement standard for limit orders priced outside the inside market. Although typically trades occur at or inside the best inside market, firms may trade proprietarily outside the best inside market for a variety of reasons, such as where there is little or no depth at the inside market or the inside market is manual or not easily accessible. Under the current requirements, such trades would trigger all limit orders priced outside the inside market, no matter how far outside the inside market the limit order is priced. For example, the best inside market for a security is \$.50 to \$.51. The member is displaying a quote to buy at \$.49 and also is holding a customer limit order to buy priced at \$.45. The member's quotation is accessed by another broker-dealer and the member buys at \$.49. Under the current requirements, the member would be required to fill the customer's purchase order at \$.45 because it had not purchased at the inside market of \$.50.

FINRA does not believe this is an appropriate result, and is therefore proposing that, where the limit order is priced outside the inside market for the security, the minimum amount of price improvement required must either meet the same tiered minimum price improvement standards set forth above or the member must trade at a price at or inside the best inside market for the security. FINRA believes this will continue to require an appropriate amount of price improvement for a member to trade ahead of a customer limit order, irrespective of whether the limit order is priced inside or outside the best inside market.

¹¹ Other than the proposed distinction to address permissible subpenny quoting and trading in OTC equity securities priced over \$1.00, the proposed price-improvement standards will apply uniformly to NMS stocks and OTC equity securities. See supra note 8.

As noted above, FINRA proposes to implement the proposed rule change on the final implementation date of SR-NASD-2005-146, November 26, 2007.

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 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. 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 original filing, SR-NASD-2005-146, which proposed the recently approved price-improvement standards, was subject to notice and comment.¹³ No comments were received in response to the Federal Register publication of that filing. However, following Commission approval, several broker-dealers raised concerns regarding the application of the amended price-improvement standards, in particular for securities trading below \$.01 and those trading outside the best inside market. One broker-dealer indicated that the inside market may not be a good reflection of trading in certain OTC equity securities. With respect to these low-priced OTC equity securities, the broker-dealer indicated that the amended price-improvements standards

¹² 15 U.S.C. 78o-3(b)(6).

¹³ See Securities Exchange Act Release No. 54705 (November 3, 2006), 71 FR 65863 (November 9, 2006) (Notice of filing of SR-NASD-2005-146).

could result in a minimum price improvement that is significantly greater than the value of the security. In addition, certain broker-dealers indicated that, under the amended minimum price improvement standards, firms that trade proprietarily outside the best inside market would trigger all customer limit orders outside the best inside market. These broker-dealers recommended that FINRA revisit the amended price-improvement standards to better address trading in low-priced securities and trading outside the best inside market.

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 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-2007-041 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, 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, on official business days between the hours of 10:00 am and 3:00 pm. 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 Market Regulation, pursuant to delegated authority.¹⁴

Florence E. Harmon
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).