

Practice has been approved by the Board.

A member firm that accepts and holds an unexecuted limit order from a customer (whether its own customer or a customer of another member) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order [under the specific terms and conditions by which the order was accepted by the firm], shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Article III, Section 1 of the Rules of Fair Practice, provided that, until September 1, 1995, customer limit orders in excess of 1,000 shares received from another member firm shall be protected from the market maker's executions at prices that are superior but not equal to the limit order, and provided further, that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders for customer accounts that meet the definition of an "institutional account" as that term is defined in Article III, Section 21(c)(4) of the Rules of Fair Practice. Nothing in this section, however, requires members to accept limit orders from any customer[s].

By rescinding the safe harbor position and adopting this Interpretation of the Rules of Fair Practice, the NASD Board wishes to emphasize that members may not trade ahead of customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. The NASD believes that, pursuant to Article III, Section 1 of the Rules of Fair Practice, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firms' market making capacity does not occur. For purposes of this Interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer's limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market making unit may not trade ahead of that customer's limit order.

The Board also wishes to emphasize that all members accepting customer limit orders owe those customers duties

of "best execution" regardless of whether the orders are executed through the member's market making capacity or sent to another member for execution. As set out above, the best execution Interpretation requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. The NASD emphasizes that the order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

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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, the 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. The 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

The purpose of the amendment to the proposed rule change is to clarify that the Interpretation's "terms and conditions" exception to the protection of customer limit orders, whether the order is from a member's own customer or is a customer limit order sent to it for execution from another member (so-called "member-to-member" limit orders), is intended to apply only to limit orders from institutional accounts as that term is defined in Article III, Section 21(c)(4) of the Rules of Fair Practice. The background and rationale for this amendment to the proposed rule change are discussed below.

On December 23, 1994, the Commission published for comment the NASD's proposed rule to expand the scope of limit order protection beyond that presently afforded by member firms to their customers in the Nasdaq Stock Market.² The NASD's current Interpretation to the Rules of Fair Practice makes it a violation of just and equitable principles of trade for a member firm to trade ahead of its own

customer's limit orders. The proposal before the Commission now would extend this protection to limit orders from a customer of a firm that sends that customer's limit order to another member for execution (so-called "member-to-member" limit orders). In addition, the proposal has a phase-in period until September 1, 1995, in which a firm receiving a member-to-member limit order of greater than 1,000 shares would be prohibited from trading for its own account at prices that are superior but not equal to the limit order price. The NASD's proposal also maintained language from the existing Interpretation regarding the member's ability to negotiate with any customer specific terms and conditions regarding its acceptance of limit orders, provided that the member makes these conditions clear to the customer. It is that language that this amendment is intended to affect.

The NASD believes that it is necessary to clarify that the terms and conditions exception to the handling of limit orders is intended to apply only to customer orders from institutional accounts as that term is defined in Article III, Section 21(c)(4) of the Rules of Fair Practice. Using that definition, a firm could negotiate limit order terms and conditions if the order came from:

- Banks, savings and loan associations, insurance companies, or registered investment companies;
- Investment advisers registered under Section 203 of the Investment Advisers Act of 1940; and
- Any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

Accordingly, under the amended language, a member firm that accepts a limit order from a person or entity that does not fall within the definition of institutional account may not initiate the negotiation of any terms and conditions on the acceptance of that limit order. On the other hand, if the account placing the limit order meets the terms of the definition of institutional account, the firm may negotiate special terms and conditions with the customer of that account, or its representative, that permit the firm to trade ahead of or at the same price as the limit order. The amended Interpretation would apply to limit orders placed by the firm's own customers and member-to-member limit orders.

The NASD believes that this approach should minimize a retail customer's potential for confusion regarding the acceptance of a limit order that, under the existing Interpretation, could have

² Securities Exchange Act Release No. 35122 (Dec. 20, 1994), 59 FR 66389 (Dec. 23, 1994).