Notice to Members

NOVEMBER 2003

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Senior Management
Trading And Market Making

KEY TOPICS

Limit Order Protection
Market Making
Multiple MPIDs

INFORMATIONAL

Limit Order Protection

Guidance Relating to the Application of NASD's Limit Order Protection Rule When Trading Proprietarily Through a Separate MPID

Executive Summary

Recently The Nasdaq Stock Market, Inc. (NASDAQ) began permitting market makers and ECNs to request the use of a second Market Participant Identifier (MPID) in the NASDAQ quotation montage for the entry of quotes and orders and the display of quotations. Because members now may enter and display quotes and orders from other desks in a separate MPID, members have sought clarification concerning the applicability of previous guidance relating to Interpretive Material 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the "Manning Rule") provided in *Special Notice to Members (NtM) 95-43* (June 5, 1995). Specifically, *NtM 95-43* provided a "no knowledge" interpretation to the Manning Rule such that, if a firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent a non-market-making desk from obtaining knowledge of customer limit orders held at the firm's market-making desk, those other desks trading in a proprietary capacity may continue to trade at prices the same as or inferior to the customer limit orders held by the market-making desk. As described in more detail in this *Notice*, members using multiple MPIDs may continue to rely on the "no knowledge" interpretation to Manning contained in *NtM 95-43* if they have established appropriate and effective information barriers between market-making desks and other trading desks exclusively engaged in proprietary trading.

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Questions/Further Information

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

Background

The Manning Rule generally prohibits market makers from trading for their own account at prices that would satisfy a customer's limit order in NASDAQ and listed securities, unless the market maker immediately thereafter executes the customer limit order.[1] The legal underpinnings for the Manning Rule are the members' basic fiduciary obligations and the requirement that they must, in the conduct of their business, "observe high standards of commercial honor and just and equitable principles of trade."[2] The Manning Rule codified an NASD disciplinary decision, which was affirmed by the SEC, that it was inconsistent with the member's fiduciary duty to compete with the customer with respect to the subject matter of their relationship: the execution of the customer's order. While the rule is written specifically to cover trading by market makers in their market-making capacity, NASD's long-held position is that a member's best-execution duty imposes the Manning obligation on all members, whether or not they are trading in a market-making capacity.[3] Based on this interpretation, members sought guidance as to how Manning should be applied to a firm that has a market-making desk and several other non-market-making desks (*e.g.*, an arbitrage desk) that trade NASDAQ securities exclusively on a proprietary basis.

At issue was the question of whether proprietary transactions by these other desks would "trigger" the Manning obligation and require the firm to fill the customer limit orders held by the market-making desk. *NtM 95-43* stated that it would be inconsistent with a member's best execution obligation for these other desks knowingly to trade ahead of a customer's limit order. However, NASD clarified its position on this issue in *NtM 95-43* by establishing a "no knowledge" interpretation relating to whether trades by non-market-making desks trigger Manning. Specifically, the *Notice* stated that "[a]s long as a firm implements and utilizes an effective system of internal controls, such as appropriate 'Chinese walls,' that operate to prevent the non-market-making desk from obtaining knowledge of customers' limit orders, those other desks may continue to trade at prices the same as or inferior to the customers' limit orders."[4]

Recently, members have sought clarification concerning the applicability of the Manning Rule and *NtM 95-43*'s "no knowledge" interpretation in the context of using an additional unattributable MPID (hidden behind the SIZE MPID) or an additional displayed MPID (displayed in the quotation montage) to represent proprietary trading interest from a non-market-making desk. Specifically, members have inquired whether proprietary trades executed by a non-market-making desk through the use of such unattributable or attributable additional MPIDs would result in a Manning obligation to customer limit orders held by the market-making desk.

In response, NASD staff is clarifying that, as stated in *NtM 95-43*, if the firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-making desks engaged exclusively in proprietary trading from obtaining knowledge of customer limit orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices the same as or inferior to the customer limit orders held at the market-making desk. An effective system of internal controls must include specific policies and procedures that prevent each of the desks separated by information barriers from obtaining knowledge regarding orders or trading activity of the other desks. For example, if a trader or other person associated with a market-making desk, having observed the quotation activity of an affiliated non-market-making desk via a second MPID, attempted to contact that desk to obtain any information about the non-market-making desk's past, current, or future trading plans, such conduct would be inconsistent with the establishment of an effective system of internal controls and therefore would trigger Manning obligations for the market-making desk based on trading activity by the non-market-making desk. Conversely, knowledge of a quotation displayed by another proprietary desk using a separate MPID or a presumption based on publicly available information that the other proprietary desk may have executed a trade (*e.g.*, a transaction accompanied by a quote decrementation), would not, in and of itself, trigger Manning obligations, if an effective system of internal controls between these desks had been established.

Members are reminded that NASD will continue to examine and review members using information barriers for compliance with this and other applicable information barrier standards. In addition, NASD Rule 3010 requires that members establish and maintain a supervisory system that is designed to ensure compliance with the NASD rules. Accordingly, NASD will examine closely members' supervisory systems and written supervisory procedures and, where appropriate, initiate disciplinary action against firms and their supervisory personnel for failure to adopt, implement, and enforce appropriate supervisory procedures. NASD also will impose significant sanctions if it finds that members have intentionally compromised their information barriers to the detriment of customer orders.

Endnotes

1 For example, if the market maker bought 100 shares at $10 when holding customer limit orders to buy at $10 equaling, in aggregate, 1000 shares, the market maker is required to fill 100 shares of the customer limit orders.

2 *See* NASD Rule 2110.

3 *See NtM 95-43* at p. 309.

4 Id.