Regulatory Notice

12-52

Front Running

SEC Approves Consolidated Front Running Rule

Effective Date: June 1, 2013

Executive Summary

Effective June 1, 2013, FINRA Rule 5270 addressing the front running of block transactions will replace NASD IM-2110-3 in the Consolidated FINRA Rulebook.¹ Among other changes, Rule 5270 applies to a broader range of securities than IM-2110-3, includes new Supplementary Material regarding permitted transactions, and codifies that front running of a customer order may violate other FINRA rules or the federal securities laws.

The text of the new rule is available in the online FINRA Manual.

Questions concerning this *Notice* should be directed to Brant K. Brown, Associate General Counsel, Office of General Counsel at (202) 728-6927.

Background & Discussion

On September 4, 2012, the SEC approved FINRA's proposal to adopt NASD IM-2110-3, with the changes discussed below, as FINRA Rule 5270 in the Consolidated FINRA Rulebook.² Rule 5270 provides that no member or person associated with a member shall cause to be executed an order to buy or sell a security or a related financial instrument when the member or person associated with the member causing the order to be executed has material, non-public market information³ concerning an imminent block transaction⁴ in that security, a related financial instrument or a security underlying the related financial instrument prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete.⁵ The rule applies to orders caused to be executed for (1) any account in which the member or person associated with the member has an interest, (2) any account with respect to which the member or person associated with the member exercises investment discretion, and (3) any account of customers or affiliates of the member when the customer or affiliate has been provided such material, non-public market information by the member or any person associated with the member.⁶

December 2012

Notice Type

- ► Consolidated Rulebook
- ► New Rule

Suggested Routing

- ► Compliance
- ► Legal
- ▶ Operations
- ► Senior Management
- ➤ Systems
- ▶ Trading

Key Topics

- ► Customer Order Protection
- ► Front Running

Referenced Rules & Notices

- ► FINRA Rule 0150
- ► FINRA Rule 2010
- ► FINRA Rule 5270
- ► FINRA Rule 5320
- ► FINRA Rule 6730
- ► NASD IM-2110-3
- ► NTM 05-51
- ► NTM 97-57
- ► NTM 96-66
- ► NTM 87-69
- ► Regulatory Notice 10-24



Rule 5270 differs from IM-2110-3 in several important ways. First, the trading restrictions in Rule 5270 apply to a broader range of securities than IM-2110-3. Second, Rule 5270 includes new Supplementary Material .04 regarding permitted transactions that replaces the exceptions in IM-2110-3. Finally, new Supplementary Material .05 codifies that the front running of any customer order, not just imminent block transactions, that places the financial interests of the firm ahead of those of its customer or the misuse of knowledge of an imminent customer order may violate other FINRA rules, including FINRA Rules 2010 and 5320, or the federal securities laws. Each of these changes is discussed below.

Expansion of Transactions

The front running prohibitions in Rule 5270 address trading in significantly more types of securities than IM-2110-3.8 Rule 5270 covers trading in an option, derivative or other financial instrument overlying a security that is the subject of an imminent block transaction if the value of the underlying security is materially related to, or otherwise acts as a substitute for, such security, as well as any contract that is the functional economic equivalent of a position in such security (individually or collectively a "related financial instrument").9 The reverse is also true: When the imminent block transaction involves a related financial instrument, Rule 5270 prohibits trading in the underlying security. Rule 5270 also applies to trading in the same security or related financial instrument that is the subject of an imminent block transaction.

Like IM-2110-3, the trading restrictions imposed by Rule 5270 generally apply until information about the imminent customer block transaction "has been made publicly available," which the rule defines as having been disseminated to the public in trade reporting data. However, because Rule 5270 includes related financial instruments that may not result in publicly available trading information being made available, the prohibitions in the rule are in place until the material, non-public market information is either publicly available or "otherwise becomes stale or obsolete." ¹¹

Permitted Transactions

Supplementary Material .04 sets forth three broad categories of permitted transactions: (1) transactions that a firm can demonstrate are unrelated to the customer block order, (2) transactions that are undertaken to fulfill or facilitate the execution of the customer block order, and (3) transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange.¹²

Supplementary Material .04(a) permits transactions that a firm can demonstrate are unrelated to the material, non-public market information received in connection with the customer block order. The Supplementary Material provides examples of transactions that,

depending upon the circumstances, may be considered to be unrelated to the customer block order and, therefore, permitted under the rule. These transactions could include transactions where the firm has effective information barriers established to prevent internal disclosure of customer order information,¹³ transactions in the security that is the subject of the customer block order that are related to a prior customer order in that security, transactions to correct bona fide errors and transactions to offset odd-lot orders. For each of these types of transactions, the firm must be able to demonstrate that the transaction at issue was unrelated to the customer block order. Thus, for example, if the firm can demonstrate that transactions occurring in a security (or a related financial instrument) that is the subject of an imminent customer block order were undertaken by a desk that is walled off from the desk handling the customer block order by the use of effective information barriers, the trading activity would be unrelated to the customer block order and would not violate the rule.¹⁴

The second category of permitted transactions involves transactions that are undertaken to fulfill or facilitate the execution of the customer block order. FINRA has acknowledged that firms are permitted to trade ahead of a customer's block order when the purpose of the trading is to fulfill the customer order and when the customer has authorized the trading, including that the firm has disclosed to the customer that it may trade ahead of, or alongside, the customer's order. Supplementary Material .04(b) states that Rule 5270 does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, a customer's block order. However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the firm must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the firm's financial interests ahead of those of its customer and must obtain the customer's consent to the trading activity.

The third, and final, category of permitted transactions is addressed in Supplementary Material .04(c) and concerns transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange. This provision states that the prohibitions in Rule 5270 shall not apply if the firm's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.

Other Rules

Rule 5270 does not provide an exhaustive list of prohibited front running activity, and Supplementary Material .05 clarifies that the front running of other types of orders that may not be "imminent block transactions" may nonetheless be considered conduct inconsistent with just and equitable principles of trade and may violate other FINRA rules or provisions of the federal securities laws.¹⁸

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Endnotes

- See Securities Exchange Act Release No. 67774 (September 4, 2012), 77 FR 55519 (September 10, 2012) (Order Approving File No. SR-FINRA-2012-025). The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice 03/12/08 (Rulebook Consolidation Process).
- Securities Exchange Act Release No. 67774 (September 4, 2012), 77 FR 55519 (September 10, 2012).
- The violative practices in Rule 5270 may include transactions that are executed based upon knowledge of less than all of the terms of the block transaction, so long as there is knowledge that all of the material terms of the transaction have been or will be agreed upon imminently. See Rule 5270.01. This provision, which remains substantively the same as the standard in IM-2110-3, is intended to make clear that a firm need not know every detail of a potential block order for the front running prohibitions to attach. FINRA has also provided similar guidance in the past in the context of volume-weighted average price transactions. See Notice to Members 05-51 (stating that a duty to refrain from trading may exist "before a member is awarded an order for execution [and] will turn on, among other factors, the type of order and the specifics of the order known by the member," which may include the security, the size of the order, the side of the market, the weighting of a basket order, and the timing for completion of the order). Exactly

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- when the front running prohibitions may attach depends upon the facts and circumstances of the communications between the firm and its customer.
- Supplementary Material .03 retains the general scope of the term block transaction from IM-2110-3. It provides that, for purposes of equity securities, a transaction involving 10,000 shares or more of a security, an underlying security, or a related financial instrument overlying such number of shares, is generally deemed to be a block transaction; however, a transaction of fewer than 10,000 shares could be considered a block transaction in some cases. Supplementary Material .03 also notes that a block transaction that has been agreed upon does not lose its identity as such by arranging for partial executions of the full transaction in portions which themselves are not of block size if the execution of the full transaction may have a material impact on the market.
- 5. The term "related financial instrument" is defined as any option, derivative, security-based swap or other financial instrument overlying a security, the value of which is materially related to, or otherwise acts as a substitute for, the security, as well as any contract that is the functional economic equivalent of a position in such security. See Rule 5270(c).
- 5. See Rule 5270(b).
- Although "not held" orders are not subject
 to the restrictions in FINRA Rule 5320, front
 running a "not held" order that is not of block
 size may nonetheless violate FINRA Rule
 2010. See Securities Exchange Act Release
 No. 63895 (February 11, 2011), 76 FR 9386
 (February 17, 2011) (Order Approving File No.
 SR-FINRA-2009-090). If the "not held" order is
 of block size, Rule 5270 would apply to trading
 activity ahead of the order.

- IM-2110-3 is limited to transactions in equity securities and options that are required to be reported on a last sale reporting system and to any transaction involving a security future, regardless of whether the transaction is reported.
- FINRA Rule 5270 does not apply to orders or transactions involving government securities. FINRA Rule 0150(c) lists the rules applicable to transactions in, and business activity relating to, "exempted securities," which include government securities. Rule 5270 is not included in the list of rules applicable to transactions in, and business activities relating to, "exempted securities" and therefore does not apply to orders or transactions involving "exempted securities." The term "exempted securities" for purposes of Rule 0150 has the same meaning as that in Section 3(a)(12) of the Securities Exchange Act of 1934 ("Act"). See FINRA Rule 0150(a). Section 3(a)(12) of the Act defines "exempted security" or "exempted securities" to include, among other things, government securities. See 15 U.S.C. 78c(a)(12), (a)(42). FINRA notes, however, that actions for similar front running conduct occurring in the exempted securities markets, including the government securities market, continue to be covered by FINRA Rule 2010.
- 10. Supplementary Material .02 retains the analysis of when information is considered "publicly available" from IM-2110-3 and states that "[t]he requirement that information concerning a block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported."
- 11. Whether information has become "stale or obsolete" for purposes of Rule 5270 will depend upon the particular facts and circumstances involved, including specific information the member firm has regarding the transaction,
- but could include factors such as the amount of time that has passed since the member learned of the block transaction, subsequent trading activity in the security, or a significant change in market conditions. The "stale or obsolete" standard supplements the dissemination standard; it does not replace it. Consequently, where there is a transparency regime in place with respect to the security or financial instrument (i.e., transactions are subject to prompt reporting requirements and the transaction reports are disseminated) the trading restrictions in Rule 5270 are linked to actual reporting and dissemination rather than by invoking the "stale or obsolete" standard. This would include debt securities subject to TRACE reporting requirements, even though the TRACE reporting requirements generally allow for up to 15 minutes to report transactions in corporate and agency debt securities. See FINRA Rule 6730(a). FINRA notes that there should generally be minimal, or no, delay between the execution of an order and the reporting of the trade. See, e.g., Regulatory Notice 10-24 (April 2010). Where there is no reporting and dissemination regime in place for a security or related financial instrument, once the customer's order is executed and the risk of the transaction has transferred from the customer to the firm, there would be no trading restrictions imposed by Rule 5270.
- 12. Supplementary Material .04 replaces the provisions in IM-2110-3 excepting transactions executed in automatic execution systems and positioning activity when a firm receives an order of block size relating to both an option or security future and the underlying security. Any trading activity that fell within the exceptions in IM-2110-3 would need to meet one of the exceptions in Supplementary Material .04 to comply with Rule 5270.

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- 13. In addition to more traditional information barriers, such as those in place to prevent communication between trading units, this provision could also include the use of automated systems (e.g., trades through a "black box") where the orders placed into the automated system are handled without the knowledge of a person associated with the member who may be trading in the same security. However, a person associated with a member who places an order into a "black box" or other automated system, or otherwise has knowledge of the order or the ability to access information in the system, may not then trade in the same security or a related financial instrument solely because the order ultimately was being handled by the automated system rather than by the person. Traders who have no knowledge of the order, due to the presence of an information barrier or otherwise, could continue to trade in the security or a related financial instrument. Automated systems may serve as a means by which orders are handled and information regarding those orders is unavailable to other trading units; however, the use of an automated system does not permit trading by those persons who may know the terms of the order placed into the automated system.
- 14. This approach is compatible with the existing provisions concerning customer order protection in Rule 5320 and its accompanying Supplementary Material concerning protection of customer limit and market orders and the implementation of effective information barriers.

- 15. See Notice to Members 05-51 (August 2005); Notice to Members 97-57 (September 1997). Hedging and positioning activity around a customer block order was discussed in coordinated guidance published by both NASD and NYSE in 2005 with respect to volumeweighted average price transactions. See Notice to Members 05-51; NYSE Information Memo 05-52 (August 2005).
- These transactions may include, for example, hedging or other positioning activity undertaken in connection with the handling of the customer order.
- 17. The Supplementary Material provides that a firm may obtain its customers' consent through affirmative written consent or through means of a negative consent letter. The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders, and if the customer does not object, then the firm may reasonably conclude that the customer has consented and may rely on the letter. In addition, a firm may provide clear and comprehensive oral disclosure to, and obtain consent from, the customer on an order-byorder basis, provided the firm documents who provided the consent and the consent evidences the customer's understanding of the terms and conditions for handling the customer's order.
- 18. IM-2110-3 also did not provide an exhaustive list of prohibited front running trading. *See*<u>Notice to Members 87-69</u> (October 1987);

 <u>Notice to Members 96-66</u> (October 1996).

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