Regulatory Notice 13-12

March 2013

Notice Type
- Rule Amendment

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management
- Systems
- Trading

Key Topics
- Clearly Erroneous Transactions
- Limit Up/Limit Down (LULD)
- Market-Wide Circuit Breakers
- NMS Securities
- Quotations
- Trade Reporting
- Trade Reporting Facilities
- Trading Centers
- Trading Pauses

Referenced Rules & Notices
- FINRA Rule 5260
- FINRA Rule 6121
- FINRA Rule 6190
- FINRA Rule 11892
- FINRA Rule 11894
- Regulation NMS

Limit Up/Limit Down

FINRA Adopts Amendments Relating to Regulation NMS Plan to Address Extraordinary Market Volatility

Effective Date: April 8, 2013

Executive Summary

On April 8, 2013, Phase I of the joint industry Regulation NMS Plan to Address Extraordinary Market Volatility will be implemented. This *Notice* provides a brief overview of the plan and recent amendments to FINRA rules to facilitate implementation, operation and member firm compliance with the plan. FINRA has also published a set of frequently asked questions providing additional guidance.

The amended rule text is available at *www.finra.org/notices/13-12*.

Questions regarding this *Notice* may be directed to:

- Market Regulation Legal Section at (240) 386-5126;
- FINRA Operations at (866) 776-0800; or
- Office of General Counsel at (202) 728-8071.

Background and Discussion

Overview of the Plan

On May 31, 2012, the SEC approved the plan,[1] which was filed by FINRA and the other self-regulatory organizations (SROs or participants) and is designed to address the type of sudden price movements that the market experienced on the afternoon of May 6, 2010. The plan provides for a market-wide limit up and limit down (LULD) mechanism to prevent trades in NMS stocks from occurring outside of specified price bands, coupled with trading pauses in the event of more significant and prolonged price moves.

Financial Industry Regulatory Authority

The plan prohibits the display of offers at prices below the lower price band and bids above the upper price band and the execution of trades outside the price bands. The price bands are a certain percentage away from a "reference price," which is the mean price of regular way, last sale eligible trades for the security over the immediately preceding five-minute period. The chart below sets forth the applicable percentage parameters according to NMS stock category (or tier) and reference price:

Tier	Reference Price	Percentage Parameter
Tier 1 – S&P 500, Russell 1000 and selected ETPs	More than $3.00	5%
	$0.75 and up to and including $3.00	20%
	Less than $0.75	Lesser of $0.15 or 75%
Tier 2 – All other NMS stocks (provided that all rights and warrants are excluded from the plan)	More than $3.00	10%
	$0.75 and up to and including $3.00	20%
	Less than $0.75	Lesser of $0.15 or 75%
	Leveraged ETP	Percentage above multiplied by the leverage ratio of the product

To account for increased volatility around market open and market close, the percentage parameters are doubled from 9:30 to 9:45 a.m. and from 3:35 to 4:00 p.m. (or in the case of an early scheduled close, during the last 25 minutes of trading). The securities information processor (SIP) for each covered NMS stock calculates and disseminates the applicable upper and lower price bands during regular trading hours.

When one side of the market for a security is outside the applicable price band (*i.e.*, when the national best bid (NBB) is below the lower band or the national best offer (NBO) is above the upper band), the SIP will disseminate the NBB or NBO with a flag identifying it as non-executable. If the other side of the market reaches the applicable price band (*i.e.*, when the NBB is equal to the upper band or the NBO is equal to the lower band), the market will enter a limit state, and the SIP will disseminate the NBB or NBO with a flag identifying it as a limit state quotation. Trading will exit the limit state if the entire size of all limit state quotations is executed or cancelled within 15 seconds of entering the limit state. If the market does not exit the limit state within 15 seconds, then the primary listing exchange for the security will declare a five-minute trading pause. The primary listing market may also declare a trading pause when a security is in a "straddle state," which occurs when the

NBB is below the lower price band or the NBO is above the upper price band and the stock is not in a limit state. The plan sets forth procedures for reopening of trading following a trading pause, including in instances where the primary listing market is unable to reopen trading or does not report a reopening price within ten minutes after the declaration of the trading pause. During a trading pause, no trades in the paused security can be executed, but all bids and offers may be displayed.

By its terms, the plan will be implemented as a one-year pilot in two phases. The initial date of plan operations is April 8, 2013. On that date, phase I implementation will begin in select Tier 1 NMS stock symbols, with full phase I implementation completed three months after the initial date of plan operations (or such earlier date as may be announced with at least 30 days notice). During phase I, the price bands will be calculated and disseminated between 9:45 a.m. and 3:30 p.m. Phase II will commence six months after the initial date of plan operations (or such earlier date as may be announced with at least 30 days notice). Upon phase II implementation, the plan will fully apply to all NMS stocks from 9:30 a.m. to 4:00 p.m. each trading day, except in the case of an early scheduled close.

Amendments to FINRA Rules

FINRA has amended its rules to facilitate the implementation, operation and member firm compliance with the plan. The amendments are discussed more fully below.

Member Firm Compliance With the Plan

The plan requires that each SRO participant adopt a rule requiring compliance by its members with the provisions of the plan, specifically that all trading centers in NMS stocks establish, maintain and enforce written policies and procedures that are reasonably designed to comply with LULD and trading pauses. On February 11, 2013, in furtherance of its obligations under the plan, FINRA filed with the SEC a proposed rule change for immediate effectiveness to: (1) adopt new FINRA Rule 6190 and (2) amend FINRA Rules 5260 and 6121.[2] The amendments are effective on April 8, 2013.

New Rule 6190

New Rule 6190 (Compliance with Regulation NMS Plan to Address Extraordinary Market Volatility) requires member firms that are trading centers in NMS stocks to establish, maintain and enforce written policies and procedures that are reasonably designed to comply with the requirements of the plan and specifically to prevent: (1) the execution of trades at prices that are below the lower price band or above the upper price band for an NMS stock, except as permitted under the plan; (2) the display of offers below the lower price band and bids above the upper price band for an NMS stock; and (3) the execution of trades in an NMS stock during a trading pause. Pursuant to the plan, the term “trading center” has the meaning set forth in Regulation NMS under the Exchange Act.[3]

In its filing, FINRA clarified that Rule 6190 applies to firms to the extent that they are trading centers and are acting as such with respect to any given trade or quotation. For example, Firm A is an OTC market maker and also a trading center. Firm A, in its capacity as an OTC market maker, receives a customer order to sell and routes the order to an exchange or other trading center. In that instance, Firm A could rely on the exchange or other trading center to ensure compliance with the plan, and for example, if the offer were displayed in violation of the plan, FINRA would not deem Firm A to be in violation of Rule 6190.

The rule will be in effect during a pilot period to coincide with the pilot period for the plan (including any extensions to the pilot period for the plan).

Amended Rule 5260

Rule 5260 (Prohibition on Transactions, Publication of Quotations, or Publication of Indications of Interest During Trading Halts) generally prohibits firms from directly or indirectly effecting any transaction or publishing any quotation during a trading halt, including a trading pause. This rule was amended to permit the display of bids and offers during a trading pause, to the extent permitted under the plan.

Amended Rule 6121

As discussed above, the plan requires that the primary listing exchange declare a trading pause if the market does not exit a limit state within 15 seconds and also gives the primary listing exchange the discretion to declare a trading pause when a security is in a straddle state. Pursuant to the amendments, paragraph (a) of Rule 6121.01 (Trading Pauses) reflects the plan's trading pause provisions and clarifies that if trading in an NMS stock is permitted to resume after a trading pause under the plan, then FINRA may permit the resumption of OTC trading in the security if trading has commenced on at least one other national securities exchange (*i.e.*, when a transaction has been executed on an exchange, not merely when quoting has commenced on the exchange). Consistent with its current policy, FINRA expects that in most cases, it will not resume OTC trading until the primary listing market resumes trading.[4]

In addition, pursuant to the amendments, Rule 6121.01(b) provides that the current trading pause provisions, which provide for halts in individual NMS stocks due to extraordinary market volatility, continue to apply to Tier 1 and Tier 2 NMS stocks until the plan is implemented for those securities. As noted above, phase I of the plan begins on April 8, 2013, for certain Tier 1 NMS stocks. As of that date, Rule 6121.01(b) does not apply to those Tier 1 NMS stocks, but continues to apply to all other Tier 1 and Tier 2 NMS stocks. Upon full implementation of phase I, the trading pause provisions apply only to Tier 2 NMS stocks, and they will no longer be in effect upon full implementation of phase II of the plan.

Pursuant to a separate proposed rule change filed on January 29, 2013, the operative date of the Market-Wide Circuit Breaker (MWCB) pilot under Rule 6121.02 is delayed until April 8, 2013, to correspond to the initial date of operations for the plan.[5] The MWCB provisions reflect changes to the methodology for triggering market-wide circuit breakers for NMS stocks.[6]

Clearly Erroneous Transactions

On January 30, 2013, FINRA filed with the SEC a proposed rule change for immediate effectiveness to adopt new Supplementary Material .03 under Rule 11892 (Clearly Erroneous Transactions in Exchange-Listed Securities) in connection with the operation of the plan.[7] The amendments became effective on the date of filing.

New Rule 11892.03 provides that the existing provisions of Rule 11892 apply to all OTC transactions involving an exchange-listed security reported to FINRA, including transactions in NMS stocks subject to the plan (except as otherwise provided in Rule 11892.03). Notably, transactions that occur within the LULD price bands could be deemed clearly erroneous to the extent they fall within the existing clearly erroneous thresholds.[8]

FINRA recognizes that a firm may experience a technology or systems problem that results in the execution of an OTC transaction in an NMS stock outside of the LULD price bands. To address this possibility, Rule 11892.03 provides that if a member firm's technology or systems issue results in any transaction being reported to FINRA outside of the LULD price bands, a FINRA officer, acting on his or her own motion, or at the request of a member firm, shall review and deem any such trades as clearly erroneous, provided that the firm satisfies the certification requirement of the rule. Specifically, a firm requesting review of one or more transactions outside of the LULD bands must certify, in the manner and form prescribed by FINRA, that the subject transactions were the result of the firm's *bona fide* technological or systems issue.[9] Absent extraordinary circumstances, any action by a FINRA officer shall be taken in a timely fashion, generally within thirty minutes of the detection of the erroneous transaction. When extraordinary circumstances exist, any such action of the FINRA officer must be taken by no later than the start of normal market hours on the trading day following the date on which the execution(s) under review occurred.[10] A transaction that is deemed clearly erroneous pursuant to Rule 11892.03 is appealable in accordance with the provisions of Rule 11894.

In the event that the SIP experiences a technology or systems problem that prevents the dissemination of price bands, FINRA would make the determination of whether to deem transactions clearly erroneous based on paragraphs (a) and (b) of Rule 11892 and Rule 11892.01.

Endnotes

1. *See* Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (Approval Order; File No. 4-631).

   The plan was subsequently amended to, among other things, revise the implementation schedule. *See* Securities Exchange Act Release No. 68953 (February 20, 2013), 78 FR 13113 (February 26, 2013) (Notice of Filing and Immediate Effectiveness; File No. 4-631). A copy of the plan, as amended, is attached as Exhibit A to the Notice of Filing and Immediate Effectiveness.

2. *See* Securities Exchange Act Release No. 68985 (February 25, 2013), 78 FR 13922 (March 1, 2013) (Notice of Filing and Immediate Effectiveness; File No. SR-FINRA-2013-016).

3. Specifically, Rule 600(b)(78) of Regulation NMS defines "trading center" as a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

4. *See* *Regulatory Notice 10-30* (June 2010).

5. *See* Securities Exchange Act Release No. 68778 (January 31, 2013), 78 FR 8668 (February 6, 2013) (Notice of Filing and Immediate Effectiveness; File No. SR-FINRA-2013-011).

6. *See* Securities Exchange Act Release No. 67090 (May 31, 2012), 77 FR 33531 (June 6, 2012) (Approval Order; File No. SR-FINRA-2011-054).

7. *See* Securities Exchange Act Release No. 68808 (February 1, 2013), 78 FR 9083 (February 7, 2013) (Notice of Filing and Immediate Effectiveness; File No. SR-FINRA-2013-012).

   The amendments also extend the effective date of the clearly erroneous pilot under Rule 11892 until September 30, 2013. The pilot provides for uniform treatment among the SROs: (1) of clearly erroneous execution reviews in multi-stock events involving twenty or more securities; and (2) in the event transactions occur that result in the issuance of an individual stock trading pause by the primary market and subsequent transactions that occur before the trading pause is in effect for transactions otherwise than on an exchange.

8. For example, assume that a Tier 1 NMS stock has a reference price of $100.00 pursuant to both the plan and Rule 11892. The lower price band would be $95.00 and the upper price band would be $105.00 under the plan. An OTC execution could occur at $96.00, which is within the plan's price bands. However, an execution at $96.00 could be subject to review as potentially clearly erroneous because it exceeds the 3 percent threshold under Rule 11892(b)(1) for securities priced above $50.00. Thus, the amendments maintain the status quo with respect to reviews of clearly erroneous transactions and the application of objective numerical guidelines by FINRA, and they do not change the discretion afforded to FINRA in connection with such reviews.

9. FINRA will provide additional information, including the required certification form, on the LULD page of the FINRA website at *www.finra.org/Industry/Compliance/MarketTransparency/TRF/LULD*.

   During for cause reviews of clearly erroneous trades or examinations of member firms, FINRA will review whether there is sufficient documentation to reasonably substantiate the certifications, as well as the firm's procedures for complying with the plan.

10. FINRA notes that additional time may be required to, for example, obtain the required certification from a member firm, verify facts or coordinate with outside parties, including the SIP responsible for disseminating the price bands and other SROs. Thus, FINRA has maintained some flexibility to make a determination outside of the 30 minute guideline.