

Best Execution and Interpositioning

SEC Approves Amendments Regarding Best Execution and Interpositioning

Effective Date: September 8, 2009

Executive Summary

The SEC approved amendments to NASD Rule 2320's requirements concerning a firm's best execution obligations and interpositioning.¹ As amended, the rule applies the standards in Rule 2320(a) to the execution of all customer orders, including those involving interposed third parties. The changes became effective September 8, 2009.

The text of the amendments can be found in the online FINRA Manual at www.finra.org/finramanual.

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

Background & Discussion

NASD Rule 2320(a) requires firms and their associated persons to use reasonable diligence to ascertain the best market for a security when handling transactions for or with a customer or a customer of another broker-dealer. Among the factors to be considered in determining whether a firm has used reasonable diligence are:

- the character of the market for the security;
- the size and type of transaction;
- the number of markets checked;
- accessibility of the quotation; and
- the terms and conditions of the order.

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Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management
- Trading

Key Topics

- Best Execution
- Interpositioning

Referenced Rules & Notices

- FINRA Rule 2010
- NASD Rule 2320
- NASD Rule 2440

In addition, Rule 2320(a) requires that the firm buy or sell in the best market “so that the resultant price to the customer is as favorable as possible under prevailing market conditions.” Prior to the amendments, NASD Rule 2320(b) stated that a firm was prohibited from interposing a third party between the firm and the best available market for a security unless the firm could demonstrate that, to its knowledge, “at the time of the transaction the total cost or proceeds of the transaction . . . was better than the prevailing inter-dealer market for the security.”

On September 8, 2009, the SEC approved amendments to NASD Rule 2320 regarding the interposing of a third party between a firm and the best available market for a security. The amendments delete the requirement that, if a firm interposes a third-party, the total costs and proceeds of the transaction must be better than the prevailing market and replace it with a specific obligation to apply the factors enumerated in Rule 2320(a) when a firm interjects a third party between the firm and the best available market.

FINRA adopted the new rule language because of the substantial changes to the ways in which markets function that have taken place since the rule was originally adopted, including technological advances, increased market transparency in the equities markets, and the development of electronic communication networks and order routing services. These changes enable firms, under certain circumstances, to use intermediaries and third parties to improve the handling of customer orders with no additional cost to the customer and with minimal or no delay in the execution of the customer’s order. Additionally, there are occasions when the use of a third party may be necessary to effectuate the execution of an order. For example, a firm may need to involve a third party if it receives an order for a foreign security that may not trade in the United States and the firm lacks the ability to execute the order without involving another broker-dealer. The rule change addresses the potential overbreadth of NASD Rule 2320(b) while making clear that interpositioning third parties in a way that results in customer harm is still prohibited.

NASD Rule 2320, as amended, makes clear that the standards in paragraph (a) apply to the handling of all customer orders, including those involving interposed third parties. Although the resultant price a customer pays remains a crucial factor in determining whether a firm has fulfilled its best execution obligations under Rule 2320, particularly in the context of retail customer order executions, the rule allows an analysis of a variety of factors, based on the terms of the customer’s order and instructions, rather than focusing solely on cost any time a firm interposes a third party between the firm and the best available market for a security. FINRA stresses, however, that interpositioning that is unnecessary or that violates a firm’s general best execution obligations—either because of unnecessary costs to the customer or improperly delayed executions—is still prohibited.² Thus, the rule continues to prohibit interpositioning that adversely affects the customer, and the cost to the customer remains a central part of determining whether a firm has met its best execution obligations.

Endnotes

- 1 See Securities Exchange Act Release No. 60635 (September 8, 2009), 74 FR 47302 (September 15, 2009) (Order Approving File No. SR-FINRA-2007-024).
- 2 Firms should be mindful that other FINRA rules also continue to govern the handling of customer orders and charges on those orders. In particular, FINRA Rule 2010 requires that firms and their associated persons observe high standards of commercial honor and just and equitable principles of trade. NASD Rule 2440 requires that firms charge fair prices and commissions in their dealings with customers.