

## Clearly Erroneous Transactions

### SEC Approves Consolidated FINRA Rules Governing Clearly Erroneous Transactions

Effective Date: February 15, 2010

#### Executive Summary

On December 1, 2009, the SEC approved FINRA's proposed rule change<sup>1</sup> to adopt a new set of rules governing clearly erroneous transactions in the consolidated rulebook.<sup>2</sup> The new FINRA Rule 11890 Series replaces NASD Rule 11890, IM-11890-1 and IM-11890-2 and was adopted as part of a market-wide effort by multiple self-regulatory organizations to provide transparency and finality with respect to clearly erroneous executions. Among other things, the new rule series includes a new general rule defining "clearly erroneous" transactions, separate provisions for the determination of clearly erroneous transactions depending upon whether the transaction involves an exchange-listed security or an over-the-counter equity security and procedures for appealing FINRA clearly erroneous determinations. In addition, the new rule series codifies minimum numerical criteria necessary for a transaction to qualify as clearly erroneous.<sup>3</sup>

The text of the new rules is set forth on FINRA's Web site at [www.finra.org/rulefilings/2009-068](http://www.finra.org/rulefilings/2009-068).

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

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#### Notice Type

- Consolidated FINRA Rulebook
- Rule Approval

#### Suggested Routing

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

#### Key Topic(s)

- Clearly Erroneous Transactions

#### Referenced Rules & Notices

- Information Notice 3/12/08
- Information Notice 10/6/08
- FINRA Rule 11890
- FINRA Rule 11891
- FINRA Rule 11892
- FINRA Rule 11893
- FINRA Rule 11894

## Background

NASD Rule 11890 provides that, in the event of a disruption or malfunction related to the use or operation of any quotation, communication or trade reporting system owned or operated by FINRA, or under extraordinary market conditions, designated officers of FINRA can review an over-the-counter (OTC) transaction arising out of or reported through any such quotation, communication or trade reporting system. If any such officer determines that the transaction is clearly erroneous or that action is necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest, the officer may declare the transaction null and void or modify its terms. IM-11890-1 and IM-11890-2 address rulings made by FINRA and the UPC Committee pursuant to NASD Rule 11890 and the review of those rulings. These three rules provide important safeguards against market disruptions caused by trader errors, system malfunctions or other extraordinary events that result in erroneous executions affecting multiple market participants and/or securities. FINRA has used NASD Rule 11890 in the context of events affecting a single stock, such as an extraordinary erroneous order causing a large number of trades involving multiple market participants in a single stock, and events affecting multiple stocks, such as a system malfunction resulting in a more widespread problem.

As part of the process of developing the consolidated rulebook (Consolidated FINRA Rulebook), the SEC has approved FINRA's proposal to move NASD Rule 11890, IM-11890-1 and IM-11890-2 into the Consolidated FINRA Rulebook as part of a new FINRA Rule 11890 Series governing clearly erroneous transactions.<sup>4</sup> FINRA has also amended these rules as part of a market-wide effort among multiple self-regulatory organizations (SROs) designed to provide transparency and finality with respect to clearly erroneous executions.<sup>5</sup> This market-wide effort among SROs seeks to achieve consistent results for participants across U.S. equities exchanges while maintaining a fair and orderly market, protecting investors and protecting the public interest. Unlike the rules of the U.S. equities exchanges, however, FINRA's rules also address clearly erroneous executions in OTC Equity Securities.<sup>6</sup>

## Discussion

The new FINRA Rule 11890 Series includes:

- (1) a general rule defining the term “clearly erroneous” (Rule 11891) with accompanying supplementary material;
- (2) a rule governing clearly erroneous determinations for transactions in exchange-listed securities (Rule 11892) with accompanying supplementary material;
- (3) a rule governing clearly erroneous determinations for transactions in OTC Equity Securities (Rule 11893) with accompanying supplementary material; and
- (4) a rule governing the review by the UPC Committee of FINRA staff determinations that a transaction was clearly erroneous (Rule 11894).

Each of these rules, and their accompanying supplementary material, are described in detail below.

### **FINRA Rule 11891: Definition & General Guidelines**

FINRA Rule 11891 defines the term “clearly erroneous” for purposes of the FINRA Rule 11890 Series. The rule specifies that “the terms of a transaction are ‘clearly erroneous’ when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.” This definition is consistent with the definitions used by other SROs in the recently approved market-wide clearly erroneous rule amendments.<sup>7</sup>

FINRA has also adopted four paragraphs of supplementary material to Rule 11891 to address broader issues that arise under the clearly erroneous rules. Supplementary Material .01 is based on NASD IM-11890-1 regarding a member firm’s failure to abide by clearly erroneous determinations made by FINRA or the UPC Committee. Supplementary Material .02 and .03 set forth the general standards applicable to clearly erroneous determinations and clarify that FINRA generally considers a transaction to be clearly erroneous when there is a systemic problem that involves large numbers of parties or trades, or conditions where it would be in the best interests of the market. Further, extraordinary market conditions may include situations where an extraordinary event has occurred or is ongoing that has had a material effect on the market for a security traded over the counter or has caused major disruption to the marketplace. Supplementary Material .02 also emphasizes that firms are responsible for ensuring that the appropriate price and type of order are entered into FINRA systems.

Finally, Supplementary Material .04 specifically addresses suspicious trading activities, such as unauthorized trading activity or attempts to manipulate stock prices by illegally gaining access to legitimate accounts or opening new accounts using false information (often referred to as “account intrusion”). Although FINRA continues to be concerned about protecting markets from unauthorized or illegal activity like account intrusion that could disrupt a fair and orderly market, FINRA’s clearly erroneous authority does not extend to such suspicious trading activities. Rather, such activities relate to allegations of fraud and fall outside the scope of the clearly erroneous rules. Consequently, the supplementary material clarifies this position while also noting that firms should routinely review the adequacy of their internal controls and ensure that appropriate system safeguards are in place to minimize or eliminate the potential for account intrusion.

### **FINRA Rule 11892: Review of Transactions in Exchange-Listed Securities**

Unlike NASD Rule 11890, which applies to transactions in both exchange-listed securities and OTC Equity Securities, the new FINRA Rule 11890 Series establishes different rules for determining whether a transaction is clearly erroneous depending upon whether the transaction involves an exchange-listed security or an OTC Equity Security. FINRA Rule 11892 establishes the criteria for exchange-listed securities, and FINRA Rule 11893 governs determinations involving transactions in OTC Equity Securities.

FINRA Rule 11892 and its supplementary material set forth the standards FINRA uses to determine whether a transaction in an exchange-listed security is clearly erroneous. Coordinating with other SROs with the goal of having consistency and transparency regarding the clearly erroneous process is important to the marketplace and to investors. For this reason, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA Trade Reporting Facility (TRF) or the Alternative Display Facility (ADF), FINRA will generally follow the determination of a national securities exchange to break a trade (or multiple trades) when that national securities exchange has broken one or more trades at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be consistent with market integrity and investor protection. When multiple national securities exchanges have related trades, FINRA will leave a trade(s) unbroken when any of those national securities exchanges has left a trade(s) unbroken at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be inconsistent with market integrity and investor protection.<sup>8</sup>

With respect to OTC transactions in exchange-listed securities for which there is no corresponding or related on-exchange trading activity, FINRA will follow the exchanges' criteria when making a clearly erroneous determination. In this sector of the market, consistency in application of clearly erroneous authority across markets is critical to ensure that one investor does not receive disparate treatment based solely on the ultimate execution or reporting venue of his or her order. Consequently, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA TRF or the ADF, but for which there is no corresponding or related on-exchange trading activity, FINRA will generally make its own clearly erroneous determination.<sup>9</sup> As part of the market-wide effort to provide transparency to clearly erroneous determinations, the new rules establish minimum numerical thresholds for clearly erroneous transactions. To ensure that transactions in exchange-listed securities are treated consistently regardless of where the trade is executed (*i.e.*, on an exchange or OTC), Rule 11892 replicates the numerical thresholds used by the exchange SROs to determine whether a transaction is eligible for consideration as clearly erroneous.<sup>10</sup> The rule also establishes provisions for the use of alternative reference prices in unusual circumstances, additional factors that FINRA may consider when making a clearly erroneous determination and numerical guidelines applicable to volatile market opens. Each of these provisions is modeled on similar provisions in the recently approved market-wide amendments.<sup>11</sup>

The numerical guidelines for clearly erroneous determinations for transactions in exchange-listed securities are as follows:

<b>Reference Price: Consolidated Last Sale</b>	<b>Normal Market Hours (9:30 a.m. Eastern Time (ET) to 4 p.m. ET) Numerical Guidelines (Subject Transaction's % Difference From the Consolidated Last Sale):</b>	<b>Outside Normal Market Hours Numerical Guidelines (Subject Transaction's % Difference From the Consolidated Last Sale):</b>
Greater than \$0.00 up to and including \$25.00	10%	20%
Greater than \$25.00 up to and including \$50.00	5%	10%
Greater than \$50.00	3%	6%
Multi-stock event – filings involving five or more securities by the same member will be aggregated into a single filing	10%	10%
Leveraged ETF/ETN securities	Normal market hours numerical guidelines multiplied by the leverage multiplier ( <i>i.e.</i> , 2x)	Normal market hours numerical guidelines multiplied by the leverage multiplier ( <i>i.e.</i> , 2x)

### FINRA Rule 11893: Review of Transactions in OTC Equity Securities

FINRA Rule 11893 governs clearly erroneous determinations involving transactions in OTC Equity Securities. The rule is structured similarly to FINRA Rule 11892, including numerical guidelines, the use of alternative reference prices in unusual circumstances and additional factors FINRA officers may consider when making a clearly erroneous determination. Because of the differences in the OTC and exchange markets, the numerical guidelines in Rule 11893 for transactions in OTC Equity Securities differ from the guidelines used for transactions in exchange-listed securities. In some instances, the percentage deviations set forth in the numerical guidelines for OTC Equity Security transactions are based on a sliding scale where the maximum percentage deviation applies to the lower execution price in the range and the minimum percentage deviation applies to the higher execution price in the range. The provisions in Rule 11893 regarding alternative reference prices and additional factors are substantially similar to those set forth in Rule 11892 for exchange-listed securities.

The numerical guidelines for clearly erroneous determinations for transactions in OTC Equity Securities are as follows:

Reference Price	Numerical Guidelines (Subject Transaction's Percentage Difference From the Reference Price)
\$0.9999 and under	20%
\$1.0000 and up to and including \$4.9999	Low end of range minimum 20% High end of range minimum 10%
\$5.0000 and up to and including \$74.9999	10%
\$75.0000 and up to and including \$199.9999	Low end of range minimum 10% High end of range minimum 5%
\$200.0000 and up to and including \$499.9999	5%
\$500.0000 and up to and including \$999.9999	Low end of range minimum 5% High end of range minimum 3%
\$1,000.0000 and over	3%

Supplementary material to Rule 11893 emphasizes that FINRA has historically exercised its clearly erroneous authority in very limited circumstances, particularly with respect to OTC Equity Securities. This more narrow approach for OTC Equity Securities is due to the differences in the OTC equity and exchange-listed markets, including the lack of compulsory information flows in the OTC equity market that come as a result of the listing process and the fact that aberrant trading in the OTC market is often due to issues other than systems problems or extraordinary events. The supplementary material also explains that FINRA does not expect to use its clearly erroneous authority in most situations; rather, FINRA expects the parties to settle any dispute privately.

### **FINRA Rule 11894: Review Procedures**

As noted above, the new clearly erroneous rules remove language that allows a FINRA officer to modify one or more of the terms of a transaction under review. Under the new rules, a FINRA officer will have the authority only to declare transactions null and void. An executive vice president of FINRA's Market Regulation Department or Transparency Services Department, or any officer designated by such executive vice president, may, on his or her own motion, review any transaction arising out of or reported through any FINRA facility. With respect to determinations involving transactions in exchange-listed securities, absent extraordinary circumstances, the officer shall take action generally within 30 minutes after becoming aware of the transaction. When extraordinary circumstances exist, any such action of the officer must be taken no later than the start of trading on the day following the date of execution(s) under review. With respect to determinations involving transactions in OTC Equity Securities, a FINRA officer must make a determination as soon as possible after becoming aware of the transaction, but in all cases by 3 p.m., ET, on the next trading day following the date of the transaction at issue. If a FINRA officer declares any transaction null and void, FINRA will notify each party involved in the transaction as soon as practicable, and any party aggrieved by the action may appeal such action in accordance with Rule 11894, unless the officer making the determination also determines that the number of affected transactions is such that immediate finality is necessary to maintain a fair and orderly market and to protect investors and the public interest.

Rule 11894 codifies the provisions governing the appeal to the UPC Committee of a FINRA officer's determination to declare an execution null and void.<sup>12</sup> NASD IM-11890-2, which concerns review by panels of the UPC Committee, has been incorporated into the text of Rule 11894. Under the rule, an appeal must be made in writing and must be received by FINRA within 30 minutes after the person making the appeal is given the notification of the determination being appealed. With respect to appeals regarding exchange-listed securities, the UPC Committee will render determinations as soon as practicable, but generally on the same trading day as the execution(s) under review. On requests for appeal received after 3 p.m., ET, the UPC Committee will render a determination as soon as practicable, but in no case later than the trading day following the date of the execution(s) under review. With respect to appeals regarding OTC Equity Securities, the committee will render determinations as soon as practicable, but in no case later than two trading days following the date of the execution(s) under review.

## Endnotes

- 1 See Securities Exchange Act Release No. 61080 (December 1, 2009), 74 FR 64117 (December 7, 2009) (Order Granting Approval to Proposed Rule Change; SR-FINRA-2009-068).
- 2 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, 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 member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 3 FINRA notes that, in devoting this *Notice* to announcing the effective date of a single set of rules and rule amendments, it is deviating from the protocol by which FINRA generally announces the effective dates of the new FINRA rules that are being adopted as part of the Consolidated FINRA Rulebook. See *Information Notice 10/06/08* (Rulebook Consolidation Process: Effective Dates of New Consolidated Rules; Introduction of Rule Conversion Chart). FINRA believes that a single *Notice* devoted to the new clearly erroneous rules is warranted in view of the market-wide amendments to multiple SRO clearly erroneous rules and the nature of the changes.
- 4 The rules concerning clearly erroneous transactions are part of the Uniform Practice Code (UPC). The rule filing approved by the SEC approved only the transfer of NASD Rule 11890, IM-11890-1 and IM-11890-2 into the Consolidated FINRA Rulebook. FINRA will address the remaining rules in the UPC in a separate rule filing.

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## Endnotes continued

- 5 *See, e.g.*, Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving NYSEArca's amendments to its clearly erroneous rules); Securities Exchange Act Release No. 60776 (October 2, 2009), 74 FR 51891 (October 8, 2009) (approving Nasdaq's amendments to its clearly erroneous rules); Securities Exchange Act Release No. 60781 (October 2, 2009), 75 FR 51926 (October 8, 2009) (approving NYSE's amendments to its clearly erroneous rules for equity securities).
- 6 For purposes of the clearly erroneous rules, the term "OTC Equity Security" has the same meaning as defined in FINRA Rule 6420, except that the term does not include any equity security that is traded on any national securities exchange.
- 7 *See* NASDAQ Rule 11890(a)(1); NYSE Rule 128(a); NYSE Arca Rule 7.10(a). *See also* Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving SR-NYSE-Arca-2009-36).
- 8 Under NASD Rule 11890, if a FINRA officer determined that a transaction was clearly erroneous, the officer could modify the terms of a transaction or declare the transaction null and void. Under FINRA Rules 11892 and 11893, FINRA's ability to modify a clearly erroneous execution has been eliminated, and a FINRA officer can only declare the transaction null and void.
- 9 The FINRA rules do not allow member firms to initiate reviews of transactions. All reviews conducted by FINRA are conducted on FINRA's own motion.
- 10 *See* FINRA Rule 11892(b)(1); NASDAQ Rule 11890(a)(2)(C); NYSE Rule 128(c)(1); NYSE Arca Rule 7.10(c)(1).
- 11 *See* FINRA Rule 11892; NASDAQ Rule 11890; NYSE Rule 128; NYSE Arca Rule 7.10.
- 12 A FINRA officer's determination not to break a trade is not appealable.