

## Three Quote Rule

### SEC Approves Exception to Three Quote Rule and Related Recordkeeping Requirements for Certain Foreign Securities

Effective Date: September 28, 2007

#### Executive Summary

Effective September 28, 2007, transactions in non-exchange-listed securities of a foreign issuer that is part of the FTSE All-World Index will be excluded from the application of Rule 2320(g) (Three Quote Rule) and Rule 3110(b) (Marking of Customer Order Tickets).<sup>1</sup> Also as of September 28, 2007, customer transactions in non-exchange-listed securities listed on a Canadian exchange will be excluded from the application of Rules 2320(g) and 3110(b), subject to certain conditions. NASD Rules 2320(g) and 3110(b), as amended, are set forth in Attachment A of this *Notice*.

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

#### Discussion

The Three Quote Rule originally was adopted on May 2, 1988,<sup>2</sup> as an amendment to FINRA's best execution rule and generally requires that firms that execute transactions in non-exchange-listed securities<sup>3</sup> on behalf of customers contact a minimum of three dealers (or all dealers if three or less) and obtain quotations, if there are fewer than two quotations displayed on an inter-dealer quotation system that permits quotation updates on a real-time basis. The Three Quote Rule further defined a firm's best execution obligation to customers by setting forth additional requirements for transactions in non-exchange-listed securities, particularly transactions involving relatively illiquid securities with non-transparent prices.

#### August 2007

##### Notice Type

- Rule Amendment

##### Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Operations
- Senior Management
- Systems
- Trading
- Training

##### Key Topic(s)

- Books and Records
- Foreign Securities
- Three Quote Rule

##### Referenced Rules & Notices

- NASD Rule 2320
- NASD Rule 2310
- NASD Rule 3110
- NASD Rule 6610

Since the adoption of the Three Quote Rule, the market for non-exchange-listed securities has changed significantly. FINRA has found that under certain circumstances, the Three Quote Rule can hinder, rather than further, compliance with the duty of best execution by causing significant delays in obtaining executions of customer orders, particularly orders in securities of foreign issuers. Accordingly, FINRA proposed, and the SEC approved, amendments that exclude from the application of the Three Quote Rule transactions effected in non-exchange-listed securities of foreign issuers that are part of the FTSE All-World Index.<sup>4</sup>

As amended, a firm is not subject to the Three Quote Rule in connection with transactions in non-exchange-listed securities of a foreign issuer that are part of the FTSE All-World Index. To qualify for the exception, the transaction must be executed during regular business hours of the foreign market for the security and no trading halt or other similar trading or quotation restriction may be in effect in any foreign market on which such foreign security is listed.

The amendments also codify existing exemptive relief relating to the application of the Three Quote Rule for customer transactions in Canadian securities executed on a Canadian exchange. As amended, a member firm is not subject to the Three Quote Rule in connection with any transaction for or with a customer in a non-exchange-listed security executed on a Canadian exchange, provided that (i) the firm or person associated with the firm conducts, pursuant to Rule 2320(a) and the duty of best execution, regular and rigorous reviews of the quality of the execution of such orders in such securities, and (ii) the orders are executed either in an agency or riskless principal capacity.

The amendments also provide a corresponding exclusion to the recordkeeping requirements set forth in Rule 3110(b) if the member can establish and document its reliance on the exclusions to the Three Quote Rule.<sup>5</sup> Firms continue to be required to comply with, among other rules, their best execution obligations under Rule 2320(a), and to the extent applicable, their suitability obligations under Rule 2310 (Recommendations to Customers).

The amendments to Rules 2320(g) and 3110(b) become effective on September 28, 2007.

## Endnotes

- 1 See Securities Exchange Act Release No. 56004 (July 2, 2007), 72 FR 37285 (July 9, 2007) (order approving SR-NASD-2004-130).
- 2 See Securities Exchange Act Release No. 25637 (May 2, 1988), 53 FR 16488 (May 9, 1988).
- 3 A non-exchange-listed security is defined in Rule 6610 as generally any equity security that is not traded on any national securities exchange.
- 4 The Financial Times and the London Stock Exchange operate the FTSE All-World Index. The FTSE All-World Index includes 48 different countries and approximately 3,000 securities. Securities included in the FTSE All-World Index can be obtained from the monthly FTSE All-World Review under the "Country Details" section of the review. The FTSE All-World Review is available for free on the on FTSE's Web site at <http://www.ftse.com> by registering to access the data. Daily updated constituent lists are also available to paying subscribers from FTSE and other data vendors. See Exhibit 2 to Amendment No. 2 to SR-NASD-2004-130 for a detailed description. Additional information also is available on FTSE's Web site at <http://www.ftse.com>.
- 5 Rule 3110(b) requires that members indicate on the order ticket for each transaction in a non-exchange-listed security the name of each dealer contacted and the quotations received to determine the best inter-dealer market as required by the Three Quote Rule.

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## ATTACHMENT A

Below is the text of the rule change. New language is underlined; deletions are in brackets.

### 2320. Best Execution and Interpositioning

(a) through (f) No Change.

(g) (1) Except as provided in subparagraph (3) below, [Unless two or more priced quotations for a non-exchange-listed security (as defined in the Rule 6600 Series) are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis,] in any transaction for or with a customer pertaining to the execution of an order in a non-exchange-listed security (as defined in the Rule 6600 Series), a member or person associated with a member shall contact and obtain quotations from three dealers (or all dealers if three or less) to determine the best inter-dealer market for the subject security.

(2) No Change.

(3) The requirements described in subparagraph (1) above shall not apply:

(A) when two or more priced quotations for a non-exchange-listed security are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis; or

(B) to any transaction for or with a customer pertaining to the execution of an order in a non-exchange-listed security of a foreign issuer that is part of the FTSE All-World Index if such transaction is executed during the regular business hours of the foreign market for the foreign security and no trading halt or other similar trading or quoting restriction is in effect in any foreign market on which such foreign security is listed; or

(C) to any transaction for or with a customer pertaining to the execution of an order in a non-exchange-listed security that is listed on a Canadian exchange, provided that (i) such order is executed by the member or a person associated with the member on a Canadian exchange in an agency or riskless principal capacity; and (ii) the member or a person associated with the member conducts, pursuant to NASD Rule 2320(a) and the duty of best execution, regular and rigorous reviews of the quality of the execution of such orders in such securities.

(4) Definitions

For purposes of this paragraph (g):[,]

(A) I[t]he term “inter-dealer quotation system” means any system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers.

(B) [(4) For purposes of this paragraph,] I[t]he term “quotation medium” means any inter-dealer quotation system or any publication or electronic communications network or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(5) No Change.

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### **3110. Books and Records**

(a) No Change.

**(b) Marking of Customer Order Tickets**

A person associated with a member shall indicate on the memorandum for each transaction in a non-exchange-listed security, as that term is defined in the Rule 6600 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market; however, the requirements of this subparagraph shall not apply if the member can establish and has documented that:

(1) two or more priced quotations for the security are displayed in an inter-dealer quotation system, as defined in Rule 2320(g), that permits quotation updates on a real-time basis for which NASD [Regulation] has access to historical quotation information; or

(2) the transaction is effected in compliance with Rule 2320(g)(3)(B) or (C).

(c) through (j) No Change.