Regulatory Notice 08-83

Front Running

FINRA Requests Comment on Proposed FINRA Rule Regarding Front Running of Block Transactions

Comment Period Expires: February 6, 2009

Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook), FINRA is requesting comment on proposals relating to FINRA's Front Running Policy in NASD Interpretive Material (IM) 2110-3. The proposed amendments to the Front Running Policy include broadening the scope of the rule beyond certain options and security futures to other types of derivatives, financial instruments and financial contracts, as well as adopting Supplementary Material to the rule to codify exceptions to the prohibitions.

The text of the proposed rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to the Office of General Counsel at (202) 728-8071.

Action Requested

FINRA encourages all interested parties to comment on the proposals. Comments must be received by February 6, 2009.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

December 2008

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

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

Key Topic(s)

- Front Running

Referenced Rules & Notices

- FINRA Rule 2010
- NASD IM-2110-3
- NTM 05-51
- NTM 02-73
- NTM 97-57
- NTM 87-69

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To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposals.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.[2]

Background & Discussion

Background

NASD IM-2110-3 (Front Running Policy) states that it is conduct inconsistent with just and equitable principles of trade for a member firm or an associated person of a member firm to buy or sell security futures or certain options for accounts in which the firm or associated person has an interest when the firm or associated person has material, non-public information concerning an imminent block transaction in the underlying security. Similarly, the same prohibition applies in the underlying security when the material, non-public information regarding a block transaction concerns an option or security future on that underlying security. The Front Running Policy also prohibits providing material, non-public information concerning an imminent block transaction to customers who then trade on the basis of the information. The prohibitions in the rule apply until the information concerning the block transaction has been made publicly available.

Proposed Amendments

FINRA proposes adopting IM-2110-3 as FINRA Rule 5270 and amending the Front Running Policy in several ways to broaden its scope. First, FINRA proposes extending the prohibitions in the rule. The proposed rule applies to all securities and is broadened to include trading in the same security that is the subject of an imminent block transaction as well as other financial instruments and contracts (*i.e.*, not only options and security futures) that overlay the security that is the subject of an imminent block transaction and that have a value that is materially related to the underlying security. Specifically, FINRA proposes extending the front running prohibitions to cover trading in an option, derivative, or other financial instrument overlying a security that is the subject of an imminent block transaction the value of which 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"). This proposed expansion of the rule to include all related financial instruments is intended to capture those instruments (in addition to securities) that could be used to take advantage of the knowledge of an imminent block transaction. This would include, for example, equity swaps, convertible debt, and any other type of financial instrument the value of which is materially related to, or otherwise acts as a substitute for, an underlying security. The reverse would also be true: When the imminent block transaction itself involves a related financial instrument, the proposed rule prevents trading in the underlying security. Although FINRA believes that this type of trading would generally violate existing FINRA rules, such as FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade),[3] FINRA proposes broadening the language of the Front Running Policy to apply equally to all related financial instruments rather than limiting it to security futures and certain options. Because some related financial instruments may not themselves result in publicly available trading information being made available, FINRA is also proposing that the prohibitions be in place until the material, non-public information is either publicly available or "otherwise becomes stale or obsolete."

Second, FINRA proposes deleting several existing provisions in the Front Running Policy and adopting new provisions as Supplementary Material to proposed FINRA Rule 5270. Specifically, FINRA proposes deleting the existing exceptions in the Front Running Policy for certain transactions in automatic execution systems and for positioning the other side of certain orders when a member firm receives a customer's block order relating to both an option and the underlying security or a security future and the underlying security. FINRA proposes replacing these specific exceptions with new Supplementary Material addressing permitted transactions. FINRA has long acknowledged that member firms are permitted to trade ahead of a customer's block order when the purpose of such trading is to fulfill the customer order and when the customer has authorized such trading, including that the firm has disclosed to the customer that it may trade ahead of, or alongside of, the customer's order.[4]

The proposed Supplementary Material codifies this position and notes that a member firm may engage in hedging and other positioning activity that could affect the market for the security that is the subject of the customer's block order provided that the firm has received the customer's affirmative written consent prior to receipt and/or execution of the order.[5] In those instances, the firm must still refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the firm's financial interests ahead of those of its customer. In addition, FINRA has noted that trading ahead is permitted in other limited circumstances (*e.g.*, trades to correct a *bona fide* error or to offset an odd lot order). FINRA proposes continuing to permit trading ahead in these limited circumstances, as well as trading done on a riskless principal basis, by codifying this guidance in Supplementary Material to proposed FINRA Rule 5270.

Request for Comment

In connection with the proposal, FINRA requests comment on certain aspects of proposed Rule 5270. Specifically, FINRA is requesting comment on the following:

- FINRA proposes to expand the scope of the current Front Running Policy so that Rule 5270 includes all "related financial instruments." As noted above, the proposed definition is intended to capture those financial instruments that could be used to take advantage of knowledge of an imminent block transaction in an underlying security (or vice versa). Does the proposed definition capture all such instruments? Does the proposed definition capture financial instruments that should not be included?
- As noted above, FINRA proposes replacing the two existing exceptions in the Front Running Policy with new Supplementary Material. Should FINRA retain either or both existing exceptions? Does the proposed Supplementary Material concerning permitted transactions adequately cover those types of transactions that should be excepted from the Front Running Policy?
- The proposed Supplementary Material regarding permitted transactions requires that firms receive affirmative written consent from a customer before engaging in hedging or other positioning activity that could affect the market for the security that is the subject of a customer's block order. Is affirmative written consent the appropriate requirement or should oral consent be permitted? Is disclosure sufficient? As noted above, consent is not required on a transaction-by-transaction basis; however, firms should at least annually take steps to have their customers reaffirm their consent. Should the rule include a reaffirmation requirement? If so, what should the frequency be?

In addition to the specific questions listed above, FINRA is also interested in any other issues that commenters may wish to address relating to the proposal.

Endnotes

1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.

3 The SEC recently approved the adoption of NASD Rule 2110 as FINRA Rule 2010, without substantive change, effective December 15, 2008. *See Regulatory Notice 08-57* (October 2008).

4 *See NASD Notice to Members 05-51* (August 2005); *NASD Notice to Members 97-57* (September 1997).

5 This position was discussed with respect to volume-weighted average price transactions in *NASD Notice to Members 05-51* (August 2005). As stated in that *Notice*, member firms need not obtain affirmative consent on a transaction-by-transaction basis; however, firms should at least annually take steps to have their customers reaffirm their consent.

Attachment A

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

* * * * *

PROPOSED FRONT RUNNING RULE AND SUPPLEMENTARY MATERIAL

[IM-2110-3]5270. Front Running of Block Transactions [Policy][1]

(a) [It shall be considered conduct inconsistent with just and equitable principles of trade for a] No member or person associated with a member shall cause to be executed, for an account in which such member or person associated with a member has an interest, for an account with respect to which such member or person associated with a member exercises investment discretion, or for [certain] the accounts of customers noted below [accounts, to cause to be executed]:

([a]1) an order to buy or sell a security or a related financial instrument [an option or a security future] when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in [the underlying] that security, related financial instrument or a security underlying a related financial instrument, or when a customer has been provided such material, non-public market information by the member or any person associated with a member, prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete; [or]

([b]2) an order to buy or sell an underlying security when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in a related financial instrument [an option or a security future overlying that security], or when a customer has been provided such material, non-public market information by the member or any person associated with a member; prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete.

1 The draft text is marked to show changes between IM-2110-3 and Proposed FINRA Rule 5270.

(b) For purposes of this Rule, the term "related financial instrument" shall mean any option, derivative, or other financial instrument overlying a security, the value of which 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.

• • • Supplementary Material: ————————

.01 Knowledge of Block Transactions. The violative practices in Rule 5270 [noted above] may include transactions [which] 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.

[The general prohibitions stated above shall not apply to transactions executed by member participants in automatic execution systems in those instances where participants must accept automatic executions.]

[These prohibitions also do not include situations in which a member or person associated with a member receives a customer's order of block size relating to both an option and the underlying security or both a security future and the underlying security. In such cases, the member and person associated with a member may position the other side of one or both components of the order. However, in these instances, the member and person associated with a member would not be able to cover any resulting proprietary position(s) by entering an offsetting order until information concerning the block transaction involved has been made publicly available.]

[The application of this front running policy is limited to transactions that are required to be reported on the last sale reporting systems administered by Nasdaq, Consolidated Tape Association (CTA), or Option Price Reporting Authority (OPRA). The front running policy also applies to security futures transactions regardless of whether such products are reported pursuant to such systems.]

.02 Publicly Available Information. Information as to a block transaction shall be considered to be publicly available when it has been disseminated via a last sale reporting system [the tape] or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Exchange Act, an alternative trading system under SEC Regulation ATS, or by a third-party news wire service. The requirement that information concerning the block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported.

.03 Definition of Block Transaction. A transaction involving 10,000 shares or more of a security, an underlying security, or [options or security futures covering] a related financial instrument overlying such number of shares, is generally deemed to be a block transaction, although a transaction of less than 10,000 shares could be considered a block transaction [in appropriate cases]. 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. [In this situation, the requirement that information concerning the block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported.]

.04 Permitted Transactions. Rule 5270 does not preclude trading activity executed for the purpose of fulfilling the customer block order or trading activity where the member can demonstrate it is unrelated to the material, non-public information received in connection with the customer order. For example, the prohibition in Rule 5270 does not apply to (a) transactions related to a prior customer order; (b) bona fide hedge transactions that the member can demonstrate are unrelated to the material, non-public information received in connection with the customer order and where the member has information barriers established to prevent internal disclosure of such information; (c) "black box" orders where the member has no actual knowledge that the customer order has been routed for execution; (d) trades to correct bona fide errors; and (e) odd-lot transactions to offset odd-lot orders.

A member also may engage in hedging and other positioning activity that could affect the market for the security that is the subject of the customer order provided that the member has received the customer's affirmative written consent prior to receipt and/or execution of the order. If the member obtains the customer's consent, the member must still refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interests ahead of those of its customer.

.05 Facilitation on a Riskless Principal Basis of Customer Order. The prohibition in Rule 5270 shall not apply to transactions that are executed to facilitate the execution, on a riskless principal basis, of a customer's block order. A member that relies on this exception must give the customer's order the same per-share price at which the member accumulated or sold shares to satisfy the customer's order, exclusive of any markup or markdown, commission equivalent or other fee.

.06 Front Running of Non-Block Transactions. Although the prohibitions in Rule 5270 are limited to imminent block transactions, the front running of other types of orders that place the financial interests of the member or persons associated with a member ahead of those of its customer or the misuse of knowledge of an imminent customer order may violate other FINRA rules, including Rule 2010, or provisions of the federal securities laws.