Regulatory Notice 09-15

Limit and Market Order Protection

FINRA Requests Comment on Proposed Consolidated FINRA Rules Governing Limit and Market Order Protection

Comment Period Expires: April 24, 2009

Executive Summary

As part of the process of developing a new consolidated rulebook (the Consolidated FINRA Rulebook),[1] FINRA is requesting comment on a proposal to adopt a new FINRA rule based on NASD IM-2110-2 and NASD Rule 2111. The proposed rule simplifies and clarifies these rules, as well as harmonizes the rules with NYSE Rule 92, where appropriate.

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

Questions regarding this *Notice* should be directed to:

- Stephanie Dumont, Senior Vice President and Director of Capital Markets Policy, Office of General Counsel, at (202) 728-8176; or
- Racquel Russell, Assistant General Counsel, Office of General Counsel, at (202) 728-8363.

Action Requested

FINRA encourages all interested parties to comment on the proposed rules. Comments must be received by April 24, 2009. Comments received after the close of the comment period will not be considered, although interested parties will have further opportunity to comment when the proposals resulting from this *Notice* process are filed with the SEC for approval.

March 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Trading and Market Making

Key Topic(s)

- Bona Fide Errors
- Limit Order Protection
- Market Order Protection
- "No-Knowledge" Interpretation
- Odd Lots

Referenced Rules & Notices

- NASD IM-2110-2
- NASD Rule 2211
- NASD Rule 2320
- NASD Rule 92

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Members 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

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

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.[2]

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*.[3]

Background & Discussion

A. Background

NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order) generally prohibits a member firm from trading for its own account in an exchange-listed security or an OTC equity security (*e.g.*, OTCBB and pink sheets securities) at a price that is equal to or better than an unexecuted customer limit order in that security, unless the firm immediately, in the event it trades ahead, executes the customer limit order at the price at which it traded for its own account or better.[4] The legal basis for this provision is the firm's basic fiduciary obligations under agency law and the requirement that a firm must, in the conduct of its business, "observe high standards of commercial honor and just and equitable principles of trade."[5] Similarly, NASD Rule 2111 (Trading Ahead of Customer Market Orders) generally prohibits a member firm that accepts and holds a customer market order in an exchange-listed security from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order up to the size and at the same price or better at which it traded for its own account.[6]

While there is no Incorporated NYSE Rule counterpart to IM-2110-2 and Rule 2111 (collectively referred to herein as customer order protection requirements), NYSE Rule 92 imposes similar requirements on NYSE member firms in NYSE-listed securities. NYSE Rule 92 generally prohibits NYSE members or member organizations from knowingly entering proprietary orders ahead of, or along with, customer orders that are executable at the same price as the proprietary order.

The proposed rule represents a cooperative effort between FINRA and NYSE Regulation to harmonize approaches, thus achieving greater consistency and simplifying compliance obligations for dual members (see NYSE Regulation *Information Memo 09-13*.)

B. Proposed FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders)

FINRA is soliciting comment on proposed FINRA Rule 5320, which, among other things, combines the requirements in IM-2110-2 and Rule 2111 to simplify and clarify the application of these rules, as well as to harmonize the rules with NYSE Rule 92, where appropriate.

1. Proposed FINRA Rule 5320: Integration of IM-2110-2 and Rule 2111 into a Single Rule

FINRA proposes integrating IM-2110-2 and Rule 2111 into a single rule governing firms' treatment of customer orders and applying the new rule uniformly to all equity securities, other than the no-knowledge exception as detailed below. In addition to streamlining and simplifying the rules, the proposal extends the application of Rule 2111 protections to OTC equity securities. Currently, Rule 2111 applies only to exchange-listed securities, while IM-2110-2 applies to both exchange-listed and OTC equity securities. FINRA believes the same concerns that arise with respect to trading ahead of limit orders in OTC equity securities also exist with respect to market orders and therefore, an expansion of the Rule 2111 protections to those securities is appropriate.

2. Proposed FINRA Rule 5320.01: Large Orders and Institutional Account Exceptions

Consistent with the current requirements in IM-2110-2 and Rule 2111, Supplementary Material .01 to proposed FINRA Rule 5320 provides that a firm may negotiate specific terms and conditions applicable to the acceptance of an order for institutional accounts, as defined in NASD Rule 3110, or for orders of 10,000 shares or more, unless such orders are less than $100,000 in value ("Institutional/Large-Sized Order"). Such terms and conditions may permit the firm to continue to trade alongside or ahead of an Institutional/Large-Sized Order. Firms imposing such terms and conditions on an Institutional/Large-Sized Order, including but not limited to not-held orders placed with the firm, must ensure that those terms and conditions are clearly disclosed and explained to the customer placing the Institutional/Large-Sized Order. In prior guidance, FINRA indicated that the appropriate method of disclosure will depend on the customer's level of sophistication and understanding.[7] For example, generalized, arms-length disclosure and acceptance procedures may be sufficient where the customer placing the Institutional/Large-Sized Order is sophisticated and clearly understands the disclosures being provided. However, in all cases, a firm relying on this exclusion must document such disclosures and be able to demonstrate that it has met the conditions of the exclusion. NYSE Rule 92 requires that NYSE member firms obtain either a one-time affirmative consent or consent on an order-by-order basis for NYSE-listed securities. Is that a more practicable approach and should FINRA extend NYSE's consent requirements to all securities?

3. Proposed FINRA Rule 5320.02: No-Knowledge Exception

Both the FINRA customer order protection requirements and NYSE Rule 92 have similar, but not identical, "no-knowledge" exceptions. Specifically, NYSE Rule 92, by its terms, is limited to those circumstances where the firm *knowingly* trades ahead of its customer. Accordingly, under NYSE Rule 92, a firm may trade ahead of a customer order as long as the person entering the proprietary order has no knowledge of the unexecuted customer order.[8]

Similarly, FINRA has established a "no-knowledge" interpretation to its customer order protection requirements. Under FINRA's interpretation, if a firm implements and utilizes an effective system of internal controls, such as appropriate information barriers that operate to prevent a non-market-making proprietary desk from obtaining knowledge of customer orders held at the firm's market-making desk, those "walled off" proprietary desks are permitted to trade at prices that would satisfy the customer orders held by the market-making desk without such proprietary executions triggering an obligation to fill pending customer orders at the same price or better.[9]

FINRA's no-knowledge interpretation was established at a time when the majority of retail order flow was handled by the firm's market-making desk, and therefore, permitting firms to "wall off" the market-making desk from retail order flow was viewed as detrimental to retail customers. As a result, FINRA's no-knowledge interpretation has always been limited to proprietary trading at non-market-making desks and does not permit firms to "wall off" the market-making desk from retail order flow for purposes of compliance with the customer order protection requirements.

However, as a result of significant changes in market structure and order routing protocols, FINRA recognizes that today, many firms prefer to handle retail-sized customer orders on an automated basis, separate and apart from the firm's proprietary trading desks, including the market-making desk. Such orders may be routed through algorithmic systems that automatically search out the market centers offering liquidity and immediate execution at the probable best available prices. In addition, firms have indicated that these orders are executed in conformance with FINRA's best execution requirements and that, therefore, requiring walled-off trading desks to integrate these orders for compliance with customer order protection requirements does not enhance execution quality and ultimately may be detrimental to the customer by delaying executions.[10]

In light of these changes, FINRA is soliciting comment on Supplementary Material .02 to proposed FINRA Rule 5320, which expands and codifies the current no-knowledge interpretation to include the market-making desk, consistent with NYSE Rule 92, with respect to exchange-listed securities. As part of this proposed change, should firms be required to identify separately order and trading activity by walled-off desks for purposes of regulatory reporting (*i.e.*, transaction and OATS reporting requirements)? Could firms assign a separate market participant identifier (MPID) to such desks and report accordingly? Are there any issues with such an approach?

In addition, to the extent a firm structures its order handling practices in exchange-listed securities to "wall off" customer order flow from its market-making desks, FINRA proposes requiring the firm to disclose that fact in writing to its customers. The proposed disclosure must include a description of the manner in which customer orders are handled and the circumstances under which the firm may trade proprietarily at prices that would satisfy an unexecuted customer order. The proposed disclosure would be required at account opening and on an annual basis thereafter.

FINRA does not, however, believe that these same types of changes in market structure and order handling practices have occurred with respect to the trading of OTC equity securities; these securities are generally not traded at automated market centers with the same depth of liquidity as exchange-listed securities and are not as accessible via automated algorithmic routing for best execution. Therefore, FINRA proposes limiting the expansion of the no-knowledge interpretation to only exchange-listed securities. Accordingly, FINRA proposes codifying the current no-knowledge standard, as set forth in prior *Notices*, for continued applicability to OTC equity securities.

4. Proposed FINRA Rule 5320.05: Odd Lots and Bona Fide Errors

FINRA proposes applying the customer order protection requirements to all customer orders (currently there is a blanket exclusion for odd lots), but would provide an exception for a firm's proprietary trade that (1) offsets a customer odd lot order (*i.e.*, an order less than one round lot, which is typically 100 shares); or (2) corrects a bona fide error. With respect to bona fide errors, member firms would be required to demonstrate and document the basis upon which a transaction meets the bona fide error exception. For purposes of this rule, the definition of a "bona fide error" is as defined in Regulation NMS's exemption for error correction transactions.[11]

5. Proposed FINRA Rule 5320.08: Application of the Rule Outside Normal Market Hours

FINRA proposes expanding the customer order protection requirements to apply at all times that a customer order may be executed, even outside the period of normal market hours (9:30 a.m. to 4:00 p.m.). Currently, the customer order protection requirements only apply during normal market hours and after hours (4:00 p.m. to 6:30 p.m.).

Except as noted above, the existing requirements and exceptions set forth in IM-2110-2 and Rule 2111 generally would be transferred unchanged as part of FINRA Rule 5320 into the Consolidated Rulebook. In addition to any comments on the specific proposed changes above, FINRA also is interested in any other issues that commenters may wish to address relating to the proposal, including any issues relating to the application of the proposal under differing market structures (*e.g.*, exchange vs. over-the-counter trading).

Endnotes

1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA members, 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 members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see FINRA Information Notice, March 12, 2008 (Rulebook Consolidation Process).

2 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.

3 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.

4 For example, if a firm buys 100 shares of a security at $10 per share while holding customer limit orders in the same security to buy at $10 per share equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders at $10 per share or better.

5 *See* FINRA Rule 2010 (formerly NASD Rule 2110). *See also In re E.F. Hutton & Co.* (known as the "Manning decision"), Securities Exchange Act Release No. 25887, 49 S.E.C. 829 (July 6, 1988), appeal filed, *Hutton & Co. Inc. v. SEC*, Dec. No. 88-1649 (D.C. Cir. September 2, 1988) (Stipulation of Dismissal Filed, January 11, 1989).

6 There are several exceptions to these provisions: most notably, firms are permitted to negotiate terms and conditions on the acceptance of certain large-sized orders (orders of 10,000 shares or more and greater than $100,000 in value) and orders from institutional accounts as defined in NASD Rule 3110(c)(4). (FINRA proposes adopting NASD Rule 3110(c)(4) as FINRA Rule 4512(c), without substantive change. *See Regulatory Notice 08-25* (May 2008).)

7 *See, e.g., Notice to Members 06-03* (January 2006).

8 Under NYSE Rule 92.10, a member firm or employee of a member or member organization is presumed to have knowledge of a particular customer order unless the member organization has implemented a reasonable system of internal policies and procedures to prevent the misuse of information about customer orders by those responsible for entering proprietary orders.

9 *See Notices to Members 95-43* (June 1995), *03-74* (November 2003) and *06-03* (January 2006).

10 FINRA's best execution requirements under NASD Rule 2320 generally require that, when executing a customer transaction, members use reasonable diligence to ascertain the best market for the subject security and buy or sell in that market so that the price to the customer is as favorable as possible under prevailing market conditions.

11 Securities Exchange Act Release No. 55884 (June 8, 2007) (Order Exempting Certain Error Correction Transactions from Rule 611 of Regulation NMS under the Securities Exchange Act of 1934).

Attachment A

Below is the proposed text of new FINRA Rule 5320. NASD IM-2110-2 and Rule 2111 would be deleted in their entirety.

5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

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5300. HANDLING OF CUSTOMER ORDERS

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5320. Prohibition Against Trading Ahead of Customer Orders

(a) A member that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

(b) A member must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of this Rule and Rule 5310 (currently NASD Rule 2320). A member also must ensure that this methodology is consistently applied.

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

.01 Large Orders and Institutional Account Exceptions. A member may negotiate specific terms and conditions applicable to the acceptance of an order for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 4512 (currently NASD Rule 3110), or for orders of 10,000 shares or more, unless such orders are less than $100,000 in value.

.02 No-Knowledge Exception.

(A) With respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS, if a member implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent one trading unit from obtaining knowledge of customer orders held at a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. A member that structures its order handling practices in NMS stocks to permit its market-making desk to trade at prices that would satisfy customer orders held at a separate trading unit must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the member and the circumstances under which the member may trade proprietarily at its market-making desk at prices that would satisfy the customer order.

(B) With respect to OTC equity securities, as defined in Rule 6420, if a member implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent a non-market making trading unit from obtaining knowledge of customer orders held at a separate trading unit, the non-market making trading unit may trade at prices that would satisfy customer orders held at the separate trading unit.

.03 Riskless Principal Exception. The obligations under this Rule shall not apply to a member's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another broker-dealer) (the "facilitated order"), provided that the member:

(A) submits a report, contemporaneously with the execution of the facilitated order, identifying the trade as riskless principal to FINRA (or another self-regulatory organization if not required under FINRA rules); and

(B) the member has written policies and procedures to ensure that riskless principal transactions relied upon for this exception comply with applicable FINRA rules. At a minimum these policies and procedures must require that the customer order was received prior to the offsetting principal transaction, and that the offsetting principal transaction is at the same price as the customer order and is allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution.

.04 ISO Exception. A member shall be exempt from the obligation to execute a customer order in a manner consistent with this Rule with regard to trading for its own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of SEC Regulation NMS ("ISO") where the customer order is received after the member routed the ISO. Where a member routes an ISO to facilitate a customer order and that customer has consented to not receiving the better prices obtained by the ISO, the member also shall be exempt with respect to any trading for its own account that is the result of the ISO with respect to the consenting customer's order.

.05 Odd Lot and Bona Fide Error Transaction Exceptions. The obligations under this Rule shall not apply to a member's proprietary trade that is (1) to offset a customer order that is in an amount less than a normal unit of trading; or (2) to correct a bona fide error. Members are required to demonstrate and document the basis upon which a transaction meets the bona fide error exception.

.06 Minimum Price Improvement Standards. The minimum amount of price improvement necessary for a member to execute an incoming order on a proprietary basis when holding an unexecuted limit order in that same security, and not be required to execute the held limit order is as follows:

(A) For customer limit orders priced greater than or equal to $1.00, the minimum amount of price improvement required is $0.01 for NMS stocks and the lesser of $0.01 or one-half (1/2) of the current inside spread for OTC equity securities;

(B) For customer limit orders priced greater than or equal to $.01 and less than $1.00, the minimum amount of price improvement required is the lesser of $0.01 or one-half (1/2) of the current inside spread;

(C) For customer limit orders priced less than $.01 but greater than or equal to $0.001, the minimum amount of price improvement required is the lesser of $0.001 or one-half (1/2) of the current inside spread;

(D) For customer limit orders priced less than $.001 but greater than or equal to $0.0001, the minimum amount of price improvement required is the lesser of $0.0001 or one-half (1/2) of the current inside spread;

(E) For customer limit orders priced less than $.0001 but greater than or equal to $0.00001, the minimum amount of price improvement required is the lesser of $0.00001 or one-half (1/2) of the current inside spread;

(F) For customer limit orders priced less than $.00001, the minimum amount of price improvement required is the lesser of $0.000001 or one-half (1/2) of the current inside spread; and

(G) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the member must trade at a price at or inside the best inside market for the security.

For purposes of determining the minimum price improvement standards for customer limit orders in OTC equity securities priced below $1.00 where there is no published current inside spread, members may calculate a current inside spread by contacting and obtaining priced quotations from at least two unaffiliated dealers and using the highest bid and lowest offer obtained in calculating the current inside spread. Where there is only a one-sided quote in an OTC equity security priced below $1.00, members may calculate the current inside spread by contacting and obtaining priced quotations from at least two unaffiliated dealers and using the best price obtained on the other side of the quote. Members must document the name of each dealer contacted and the quotations received for purposes of determining the current inside spread.

In addition, if the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this Rule, even if those better-priced limit orders would not be directly triggered under the minimum price-improvement standards above.

.07 Order Handling Procedures. A member must make every effort to execute a marketable customer order that it receives fully and promptly. A member that is holding a customer order that is marketable and has not been immediately executed must make every effort to cross such order with any other order received by the member on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the member and that is consistent with the terms of the orders. In the event that a member is holding multiple orders on both sides of the market that have not been executed, the member must make every effort to cross or otherwise execute such orders in a manner that is reasonable and is consistent with the objectives of this Rule and with the terms of the orders. A member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

.08 Trading Outside Normal Market Hours. Members generally may limit the life of a customer order to the period of normal market hours of 9:30 a.m. to 4 p.m. Eastern Time. However, if the customer and member agree to the processing of the customer's order outside normal market hours, the protections of this Rule shall apply to that customer's order(s) at all times the customer order is executable by the member.