Regulatory Notice 11-24

May 2011

Customer Order Protection

SEC Approves Consolidated FINRA Customer Order Protection Rule

Effective Date: September 12, 2011

Executive Summary

On February 11, 2011, the SEC approved new FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) for the consolidated FINRA rulebook (the Consolidated FINRA Rulebook).[1] Rule 5320 consolidates, updates and simplifies NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders).[2] Rule 5320 becomes effective on September 12, 2011.

Text of new FINRA Rule 5320 is available in the online FINRA Manual at *www.finra.org/finramanual*.[3]

Questions regarding this *Notice* should be directed to Racquel Russell, Assistant General Counsel, Office of General Counsel, at (202) 728-8363.

Background and Discussion

On February 11, 2011, the SEC approved a proposed rule change consolidating, updating and simplifying NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) into FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders).[4] FINRA Rule 5320 generally provides that a member firm 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.[5]

Notice Type
- Consolidated FINRA Rulebook
- New Rule

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management
- Systems
- Trading and Market Making
- Training

Key Topics
- Limit Orders
- Manning Rule
- Market Orders
- Minimum Price-Improvement Standards
- NMS Stocks
- Order Protection
- OTC Equity Securities
- Rulebook Consolidation

Referenced Rules
- FINRA Rule 4512
- FINRA Rule 5320
- FINRA Rule 6420
- NASD IM-2110-2
- NASD Rule 2111
- NASD Rule 2320
- NASD Rule 3110
- NTM 95-43
- NTM 97-57
- NTM 05-51
- SEC Regulation NMS Rule 600

FINRA

Financial Industry Regulatory Authority

FINRA Rule 5320 applies to customer market and limit orders in securities that meet the definition of "OTC Equity Security" as defined in FINRA Rule 6420,[6] as well as securities that meet the definition of "NMS stock" as defined in Rule 600 of SEC Regulation NMS.[7] With respect to customer limit orders (marketable and non-marketable), as was the case with NASD IM-2110-2, new FINRA Rule 5320 includes minimum price improvement amounts that are necessary for a firm to execute an 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 (unless an exception applies).[8] The Supplementary Material to Rule 5320 provides several exceptions, including for large orders and orders from institutional accounts; a "no-knowledge" exception; and an exception for trades made to offset a customer odd-lot order or to correct a *bona fide* error.[9]

Large Orders and Institutional Account Exceptions

Rule 5320.01 generally continues to permit firms 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))[10] that would permit firms to trade ahead of or along with such orders, provided that firms give clear and comprehensive written disclosure to such customer at account opening and annually thereafter that:

a. discloses that the firm may trade proprietarily at prices that would satisfy the customer order, and

b. provides the customer with a meaningful opportunity to opt in to the Rule 5320 protections with respect to all or any portion of its order.[11]

In lieu of providing the written disclosure to customers at account opening and annually thereafter, Rule 5320.01 would permit firms to provide clear and comprehensive oral disclosure to, and obtain oral consent from, a customer on an order-by-order basis, provided that the firm documents who provided the consent and that the consent evidences the customer's understanding of the terms and conditions of the order. When a customer has opted in to the Rule 5320 protections, a firm may still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the firm documents who provided the consent and that the consent evidences the customer's understanding of the terms and conditions of the order.

No-Knowledge Exception

Rule 5320.02 provides an exception for a firm's proprietary trading in NMS stocks where the proprietary trading unit does not have knowledge of the customer order. Specifically, if a firm implements and uses 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 by 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.[12]

If a firm structures its order-handling practices in NMS stocks to permit its market-making desk to trade at prices that would satisfy customer orders held by a separate trading unit, the firm 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 firm and the circumstances under which it may trade proprietarily at its market-making desk at prices that would satisfy the customer order.

With respect to OTC Equity Securities, if a firm implements and uses 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 by a separate trading unit, the non-market-making trading unit trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. The no-knowledge exception does not extend to the market-making desk for trading in OTC Equity Securities.

Odd Lot and Bona Fide Error Transaction Exceptions

The rule also provides an exception for firm proprietary trading made to offset a customer order that is in an amount less than a normal unit of trading (an "odd lot"). In addition, a transaction made to correct a *bona fide* error also is excepted. Firms are required to demonstrate and document the basis upon which a transaction meets the *bona fide* error exception.

Trading Outside Normal Market Hours

Supplementary Material .08 of Rule 5320 clarifies that the rule applies to a customer order at all times that the order is executable by the firm. Therefore, while firms generally may limit the life of a customer order to the period of normal market hours of 9:30 a.m. to 4:00 p.m. Eastern Time, if the customer and firm agree to the processing of the customer's order outside normal market hours, then the protections of this rule also apply to that customer's order outside of normal market hours.

FINRA Rule 5320 becomes effective on September 12, 2011.

Endnotes

1 *See* Securities Exchange Act Release No. 63895 (February 11, 2011); 76 FR 9386 (February 17, 2011) (Order Approving SR-FINRA-2009-090) (Approval Order). 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 new FINRA Rules apply to all member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see* *Information Notice 03/12/08* (Rulebook Consolidation Process).

2 Consistent with existing policy, where a provision of new FINRA Rule 5320 is not substantively different from NASD IM-2110-2 or NASD Rule 2111, previously issued interpretations generally will continue to apply (unless rescinded or updated by FINRA).

3 FINRA updates the rule text on its online *Manual* within two business days of SEC approval of changes to the rule text.

4 *See* Approval Order. FINRA understands that NYSE intends to file a proposed rule change to harmonize NYSE Rule 92 with the changes implemented in FINRA Rule 5320.

5 Rule 5320(b) provides that firms must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of the rule and NASD Rule 2320 (Best Execution and Interpositioning). Firms also are required to ensure that their methodology is consistently applied.

6 "OTC Equity Security" means any equity security that is not an "NMS stock" as that term is defined in Rule 600(b)(47) of SEC Regulation NMS, provided, however, that the term "OTC Equity Security" does not include any restricted equity security. *See* FINRA Rule 6420(e).

7 A firm that is holding a customer order that is marketable and has not been immediately executed must make every effort to cross the order with any other order received by the firm 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 firm and that is consistent with the terms of the orders. In the event that a firm is holding multiple orders on both sides of the market that have not been executed, the firm must make every effort to cross or otherwise execute the orders in a manner that is reasonable and consistent with the objectives of this rule and with the terms of the orders. A firm can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price. *See* Rule 5320.07.

8 *See* Rule 5320.06.

9 Rule 5320 also includes two additional exceptions, similar to existing provisions under NASD IM-2110-2 and NASD Rule 2111—specifically, a limited exception for riskless principal transactions and the intermarket sweep order exception. *See* Rule 5320.03 and .04.

10 As part of the Rulebook Consolidation Process, as of December 5, 2011, NASD Rule 3110(c) will become FINRA Rule 4512. *See* Securities Exchange Act Release No. 63784 (January 27, 2011); 76 FR 5850 (February 2, 2011) (Order Approving File No. FINRA-2010-052).

11 If a customer does not opt in to the Rule 5320 protections with respect to all or any portion of its order(s), the firm may reasonably conclude that the customer has consented to the firm trading a security on the same side of the market for its own account at a price that would satisfy the customer's order. Even if a customer does not opt in to the Rule 5320 protections, the firm's conduct must continue to be consistent with the guidance provided in *NTM 05-51* (August 2005) which, among other things, reminds firms that adherence to just and equitable principles of trade as mandated by Rule 2010 "requires that members handle and execute any order received from a customer in a manner that does not disadvantage the customer or place the firm's financial interests ahead of those of its customer." *See also* NASD Rule 2320.

12 Firms should indicate the existence of these information barriers in information submitted to FINRA's Order Audit Trail System (OATS) in accordance with the OATS rules and the OATS Reporting Technical Specifications on FINRA's website at *www.finra.org/OATS*.