

Regulatory Notice

12-13

Best Execution

SEC Approves Consolidated FINRA Best Execution Rule

Effective Date: May 31, 2012

Executive Summary

The SEC approved FINRA's proposed rule change to adopt FINRA Rules 5310 (Best Execution and Interpositioning) and 6438 (Displaying Priced Quotations in Multiple Quotation Mediums) in the consolidated rulebook (Consolidated FINRA Rulebook).¹ FINRA Rule 5310 is the new consolidated rule governing members' best execution requirements that is based largely on NASD Rule 2320 (Best Execution and Interpositioning). The Supplementary Material to Rule 5310 draws substantially from NASD IM-2320 (Interpretive Guidance with Respect to Best Execution Requirements) but includes several new provisions concerning securities with limited quotation or pricing information available, foreign securities, customer instructions on routing orders, and regular and rigorous review of execution quality. Rules 5310 and 6438 become effective on May 31, 2012.

The text of FINRA Rules 5310 and 6438 are available in the online FINRA manual at www.finra.org/finramanual.²

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

Background & Discussion

The SEC approved FINRA's proposed rule change to adopt FINRA Rules 5310 and 6438 in the Consolidated FINRA Rulebook.³ FINRA Rule 5310 is the new consolidated rule governing members' best execution requirements and is based largely on NASD Rule 2320. The Supplementary Material to Rule 5310 draws substantially from NASD IM-2320 but includes several new provisions that are described below.⁴ Rule 6438 replaces, but does not substantively alter, NASD Rule 2320(f)(2) requiring members to display the same priced quotation for OTC equity securities in multiple quotation mediums.⁵

March 2012

Notice Type

- Consolidated FINRA Rule

Suggested Routing

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

Key Topics

- Best Execution
- Directed Orders
- Foreign Securities
- Regular and Rigorous Review
- Three Quote Rule

Referenced Rules & Notices

- FINRA Rule 5310
- FINRA Rule 5320
- FINRA Rule 6420
- FINRA Rule 6438
- NASD Rule 2320
- NASD IM-2320
- NASD Rule 3110
- NTM 01-22



Financial Industry Regulatory Authority

FINRA Rule 5310 leaves in place the general requirements of best execution. Rule 5310(a) requires a member firm, in any transaction for or with a customer or a customer of another broker-dealer, to use “reasonable diligence” to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule identifies five factors that are among those to be considered in determining whether the firm has used reasonable diligence:

- ▶ the character of the market for the security;
- ▶ the size and type of transaction;
- ▶ the number of markets checked;
- ▶ the accessibility of the quotation; and
- ▶ the terms and conditions of the order as communicated to the firm.

Rule 5310 also includes provisions related to interpositioning (*i.e.*, interjecting a third party between the firm and the best available market), the use of a broker’s broker,⁶ the staffing of order rooms and the application of the best execution requirements to other parties.⁷

As noted above, the Supplementary Material to Rule 5310 includes the following new provisions:⁸

1. Supplementary Material .06: Securities with Limited Quotation or Pricing Information

NASD Rule 2320(f), which was commonly referred to as the “Three Quote Rule,” has been replaced with Supplementary Material .06. The new Supplementary Material emphasizes a firm’s best execution obligations when handling an order involving any security, equity or debt, for which there is limited quotations or pricing information available. It stresses that a firm must be especially diligent with respect to best execution obligations when there is limited quotation or other pricing information available regarding the security that is the subject of the order and requires the firm to have written policies and procedures in place to address the steps the firm will take to determine the best market for such a security in the absence of multiple quotations or pricing information and to document how the firm has complied with those policies and procedures.⁹ The Supplementary Material specifically notes that, when handling orders for such securities, a firm should generally seek out other sources of pricing information or potential liquidity, which may include obtaining quotations from other sources (*e.g.*, other firms that the member firm previously has traded with in the security). For example, in many instances, particularly in the context of equity securities with limited quotation information available, contacting other broker-dealers may be necessary to comply with a firm’s best execution obligations. The Supplementary Material recognizes that contacting other broker-dealers can often be necessary for a firm to meet its best execution obligations.¹⁰

2. Supplementary Material .07: Orders for Foreign Securities with No U.S. Market

Markets in foreign jurisdictions often do not have identical best execution requirements as those in the United States and, in many cases, may not have comparable pre-trade or post-trade transparency standards. Consequently, the handling of orders for foreign securities with no U.S. market can differ substantially from the handling of orders in securities that trade in the United States. Supplementary Material .07 to Rule 5310 addresses firms' best execution obligations when handling orders for foreign securities, and in particular foreign securities with no U.S. market.

Supplementary Material .07 recognizes that markets for different securities can vary dramatically and that the standard of "reasonable diligence" required by FINRA Rule 5310(a) must be assessed by examining specific factors, including "the character of the market for the security" and the "accessibility of the quotation." Accordingly, the determination as to whether a firm has satisfied its best execution obligations necessarily involves a "facts and circumstances" analysis. Supplementary Material .07 notes that even though a foreign security may not trade in the United States, firms still have an obligation to seek best execution for customer orders involving the security. Consequently, a firm that handles customer orders for foreign securities that do not trade in the United States must have specific written policies and procedures in place regarding its handling of customer orders for these securities that are reasonably designed to obtain the most favorable terms available for the customer, taking into account differences that may exist between U.S. markets and foreign markets. The Supplementary Material further notes that a firm's best execution obligations will evolve as changes occur in the market that may give rise to improved executions, including opportunities to trade at more advantageous prices. Firms must, therefore, regularly review their policies and procedures to assess the quality of executions received and update or revise the policies and procedures as necessary.

3. Supplementary Material .08: Customer Instructions Regarding the Routing of Orders

Supplementary Material .08 addresses situations where the customer has, on an unsolicited basis, specifically instructed the firm to route its order to a particular market.¹¹ Under those circumstances, the firm is not required to make a best execution determination beyond that specific customer instruction; however, the firm must process the customer's order promptly and in accordance with the terms of the order. Supplementary Material .08 also makes clear that, where a customer has directed the firm to route an order to another broker-dealer that is also a FINRA member firm, the exception would not apply to the receiving broker-dealer to which the order was directed.¹²

4. Supplementary Material .09: Regular and Rigorous Review of Execution Quality

Supplementary Material .09 codifies a firm's obligations when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers. These longstanding obligations are set forth and explained in various SEC releases and *Notices to Members*.¹³ Supplementary Material .09 codifies this guidance and does not alter existing requirements regarding regular and rigorous review.

Endnotes

1. See Securities Exchange Act Release No. 65895 (December 5, 2011), 76 FR 77042 (December 9, 2011) (Order Approving SR-FINRA-2011-052). The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from the 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. FINRA updates the rule text on its online *Manual* within two business days of SEC approval of changes to the rule text.
3. See Securities Exchange Act Release No. 65895 (December 5, 2011), 76 FR 77042 (December 9, 2011) (Order Approving SR-FINRA-2011-052).
4. IM-2320 was adopted in 2006 to codify interpretive guidance that FINRA staff had provided involving compliance with NASD Rule 2320. See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006). Specifically, IM-2320 addressed issues involving the term “market” for purposes of the rule as well as the application of the rule to debt securities and to broker-dealers that are executing a customer’s order against the broker-dealer’s quote.
5. NASD Rule 2320(f)(2) generally required members that display priced quotations on a real-time basis for a non-exchange-listed security in two or more quotation mediums that permit quotation updates on a real-time basis to display the same priced quotation in each medium except for certain customer limit orders displayed on an electronic communications network. Rule 6438 replaces the term “non-exchange-listed security” with “OTC Equity Security” to conform the rule language to other FINRA rules addressing non-NMS stocks, and the rule does not include a separate definition of “quotation medium.” For purposes of Rule 6438, the terms “OTC Equity Security” and “quotation medium” are defined in FINRA Rule 6420.
6. Certain parts of the provision concerning the use of a broker’s broker were relocated from NASD Rule 2320(b) into Supplementary Material .05 of Rule 5310.
7. FINRA also amended paragraph (e) of the rule to clarify that a firm’s best execution obligations extend to all customer orders, thus avoiding the potential misimpression that the paragraph limits the scope of the rule’s requirements.
8. Supplementary Material .01 of Rule 5310 repeats the obligation in Supplementary Material .01 to FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) that a firm must make every effort to execute a marketable customer order that it receives fully and promptly.

9. NASD Rule 3110(b) (Books and Records) generally required firms to indicate on the customer order ticket how they complied with the Three Quote Rule, if applicable. FINRA has replaced this provision with a more general documentation requirement in Supplementary Material .06 that requires firms to retain records sufficient to demonstrate that they have handled orders covered by the rule in accordance with their policies and procedures.
10. In recognizing the importance of contacting other broker-dealers for pricing or liquidity information, many firms may choose to adopt policies and procedures that are substantially similar to the Three Quote Rule but may, for example, allow for firms to adapt their procedures for certain situations if the firm reasonably concludes that those requirements would result in unnecessary delay or otherwise not benefit the customer. Firms must also continue to take into account when developing their procedures that the Three Quote Rule was a minimum standard, and contacting other dealers does not guarantee that a firm has met its best execution obligations in all cases.
11. When the order is for an NMS security, these orders are often referred to as “directed orders.” See 17 CFR 242.600(b)(19). Of note, directed orders are excluded from the order routing statistics required to be produced under Rule 606 of SEC Regulation NMS. See 17 CFR 242.606.
12. For example, if a customer of Member Firm A directs Member Firm A to route an order to Member Firm B, Member Firm B would continue to have best execution obligations to that customer order received from Member Firm A.
13. See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); *NTM 01-22* (April 2001).