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Required fields are shown with yellow backgrounds and asterisks.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2012 - * 025
Amendment No. (req. for Amendments *)

Proposed Rule Change by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☑ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☑ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3) ☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Adopt FINRA Rule 5270 (Front Running of Block Transactions) in the Consolidated FINRA Rulebook

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name * Brant Last Name * Brown

Title * Associate General Counsel

E-mail * brant.brown@finra.org

Telephone * (202) 728-6927 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 05/17/2012

By Stephanie Dumont
(Name *)

Senior Vice President and Director of Capital Markets Policy
(Title *)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Stephanie Dumont,

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information (required) Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change (required) Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt NASD Interpretive Material ("IM") 2110-3 (Front Running Policy) as FINRA Rule 5270 with the changes described below.

The text of the proposed rule change is attached as Exhibit 5 to this rule filing.

(b) Upon Commission approval and implementation by FINRA of the proposed rule change, NASD IM-2110-3 will be eliminated from the current FINRA rulebook.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meeting on September 16, 2008, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The implementation date will be no later than 90 days following publication of the Regulatory Notice announcing Commission approval.

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[1] 15 U.S.C. 78s(b)(1).

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[2] FINRA is proposing to adopt NASD IM-2110-3 ("Front Running Policy") as FINRA Rule 5270 with the changes described below.

The Front Running Policy, which was adopted as interpretive material to Article III, Section 1 of the NASD's Rules of Fair Practice[3] in 1987,[4] states that it is considered conduct inconsistent with just and equitable principles of trade for a member or an associated person of a member to buy or sell security futures or certain options for accounts in which the member or associated person has an interest when the member or associated person has material, non-public market information concerning an imminent

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2 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 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 Information Notice, March 12, 2008 (Rulebook Consolidation Process).

3 Article III, Section 1 of the NASD's Rules of Fair Practice was subsequently renumbered as NASD Rule 2110, and is now FINRA Rule 2010. See Regulatory Notice 08-57 (October 2008).

4 NASD adopted the Front Running Policy at the same time as several other self-regulatory organizations ("SROs") filed their policies regarding front running of block transactions. See Securities Exchange Act Release No. 25233 (December 30, 1987), 53 FR 296 (January 6, 1988). See also NASD Notice to Members 87-69 (October 1987).

block transaction[5] in the underlying security. Similarly, the same prohibition applies in the underlying security when the material, non-public market information regarding a block transaction concerns an option or security future on that underlying security.[6] The Front Running Policy also prohibits providing material, non-public market information concerning an imminent block transaction to customers who then trade on the basis of the information. The Front Running Policy is limited to transactions in equity securities and options that are required to be reported on a last sale reporting system and to any transaction involving a security future, regardless of whether the transaction is reported. The prohibitions apply until the information concerning the block transaction has been made publicly available (i.e., "when [the information] has been disseminated via 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 Act, an alternative trading system under Regulation ATS, or by a third-party news wire service").

Finally, the Front Running Policy includes exceptions from the general prohibitions in the rule for "transactions executed by member participants in automatic execution systems in those instances where participants must accept automatic

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5 The rule states that "[a] transaction involving 10,000 shares or more of an underlying security, or options or security futures covering 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."

6 The Front Running Policy initially applied only to certain options (either trading the option while in possession of material, non-public market information regarding an imminent block transaction in the underlying security or trading the underlying security while in possession of material, non-public market information regarding an imminent block transaction in the option). In 2002, the rule was broadened to include the same prohibitions with respect to security futures. See Securities Exchange Act Release No. 46663 (October 15, 2002), 67 FR 64944 (October 22, 2002); see also NASD Notice to Members 02-73 (November 2002).

executions" as well as situations where a member receives a customer's block order relating to both an option or security future and the underlying security and the member, in furtherance of facilitating the customer's block order, positions the other side of one or both components of the order. In the latter case, a member is still prohibited from covering any resulting proprietary position by entering an offsetting order until information concerning the block transaction has been made publicly available.

FINRA is proposing to adopt IM-2110-3 as FINRA Rule 5270 and amend the rule in several ways to broaden its scope and provide further clarity into activity that FINRA believes is inconsistent with just and equitable principles of trade. First, FINRA is proposing to extend the prohibitions in the rule to apply explicitly to all securities and 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, or otherwise acts as a substitute for, the underlying security. Specifically, FINRA is proposing to extend 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 if the value of the underlying security 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"). The reverse would also be true: when the imminent block transaction itself involves a related financial instrument, the proposed rule would prevent trading in the underlying security. The proposed rule change also extends the trading provisions in the rule to include explicitly trading in the

same security or related financial instrument that is the subject of an imminent block transaction.[7]

Although the proposed rule change would broaden the scope of trading covered by the front running rule, FINRA believes that the type of trading prohibited by the proposed rule change would generally already violate other existing FINRA rules, such as FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade). As FINRA noted when it first adopted the Front Running Policy, the adoption of the rule was never intended to imply that other forms of trading activity not explicitly covered by the Front Running Policy could not violate FINRA rules.[8] Because FINRA believes the Front Running Policy is unduly narrow in capturing the types of front running activity that are inconsistent with just and equitable principles of trade, FINRA is proposing to broaden the language of the Front Running Policy to apply equally to all related financial instruments (e.g., stock options and futures, options futures, other derivatives, and

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7 The Commission noted in the release seeking comment on the SRO front running rules that, generally, "the SROs define frontrunning as the practice of trading a security while in possession of material, non-public information regarding an imminent block transaction in the same or a related security." See Securities Exchange Act Release No. 25233 (December 30, 1987), 53 FR 296 (January 6, 1988).

8 FINRA has consistently noted that the Front Running Policy does not provide an exhaustive list of prohibited front running trading. See NASD Notice to Members 87-69 (October 1987) ("Although the Board believes it is important to provide guidelines describing the kind of [front running] conduct that will not be permitted, members and persons associated with a member should be aware that any conduct that is not consistent with their fiduciary responsibilities in this area would be a violation of [just and equitable principles of trade]."). See also NASD Notice to Members 96-66 (October 1996) (noting that although the Front Running Policy applied only to equity securities, actions for similar conduct involving government securities would violate just and equitable principles of trade).

security-based swaps) rather than be limited to equity securities, security futures, and certain options.[9]

As noted above, the trading restrictions imposed by the current Front Running Policy apply until information about the imminent customer block transaction "has been made publicly available," which the rule defines as having been disseminated to the public in trade reporting data. The proposed rule change generally retains this standard for determining when information has become publicly available; however, because FINRA is proposing to expand the rule to include related financial instruments that may not result in publicly available trading information being made available, FINRA is also proposing that the prohibitions in the rule be in place until the material, non-public market information is either publicly available or "otherwise becomes stale or obsolete."[10]

The proposed rule change also replaces several existing provisions in the Front Running Policy with Supplementary Material to FINRA Rule 5270. Specifically, FINRA is proposing to replace 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 receives a customer's block order relating to both an option and the underlying security or a security future and the underlying security with new

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9 Notwithstanding the amendments discussed in the proposed rule change, FINRA notes that, as amended, the rule is still not intended to provide an exhaustive list of prohibited trading activity. Proposed Supplementary Material .05, for example, states that front running orders not explicitly covered by the terms of Rule 5270 could nonetheless violate other FINRA rules.

10 Whether information has become stale or obsolete will depend upon the particular facts and circumstances involved, including specific information the member has regarding the transaction, but could include factors such as the amount of time that has passed since the member learned of the block transaction, subsequent trading activity in the security, or a significant change in market conditions.

Supplementary Material that identifies types of transactions that are permitted under the rule.

Under the Supplementary Material, there are three broad categories of permitted transactions: transactions that the member can demonstrate are unrelated to the customer block order, transactions that are undertaken to fulfill or facilitate the execution of the customer block order, and transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange.

The first category of permitted transactions are those that the member can demonstrate are unrelated to the customer block order. Supplementary Material .04(a) recognizes that members may engage in such transactions provided that the member can demonstrate that the transactions are unrelated to the material, non-public market information received in connection with the customer order. The Supplementary Material includes an illustrative list of potentially permitted transactions as examples of transactions that, depending upon the circumstances, may be unrelated to the customer block order. These types of transactions could include transactions where the member has effective information barriers established to prevent internal disclosure of customer order information,[11] transactions in the security that is the subject of the customer block

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[11] In addition to more traditional information barriers, such as those in place to prevent communication between trading units, this provision could also include the use of automated systems (e.g., trades through a "black box") where the orders placed into the automated system are handled without the knowledge of a person associated with the member who may be trading in the same security. However, a person associated with a member who places an order into a "black box" or other automated system, or otherwise has knowledge of the order or the ability to access information in the system, may not then trade in the same security or a related financial instrument solely because the order ultimately was being handled by the automated system rather than by the person. Traders who have no knowledge of the order, due to the presence of an information barrier or otherwise, could

order that are related to a prior customer order in that security, transactions to correct bona fide errors, and transactions to offset odd-lot orders.

For each of these types of transactions, the member must be able to demonstrate that the transaction at issue was unrelated to the customer block order. Thus, for example, if the member can demonstrate that transactions occurring in a security (or a related financial instrument) that is the subject of an imminent customer block order were undertaken by a desk that is walled off from the desk handling the customer block order by the use of effective information barriers, the trading activity would be unrelated to the customer block order and, therefore, permitted.[12]

Similarly, FINRA believes that transactions that a member can demonstrate are related to other customer orders in the same security, correct bona fide errors made in earlier transactions involving the security, or offset other odd-lot orders in the security are generally unrelated to the customer block order and therefore should be permitted.

The second category of permitted transactions involve transactions that are undertaken to fulfill or facilitate the execution of the customer block order. FINRA has acknowledged that 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

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continue to trade in the security or a related financial instrument. See infra note 22.

12 FINRA believes that this approach is compatible with the existing provisions concerning customer order protection in Rule 5320 and its accompanying Supplementary Material concerning protection of customer limit and market orders and the implementation of effective information barriers.

trade ahead of, or alongside of, the customer's order.[13] Supplementary Material .04(b) thus makes clear that Rule 5270 does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, a customer's block order.[14] However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the member must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the member's financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity. The Supplementary Material provides that a member may obtain its customers' consent through affirmative written consent or through means of a negative consent letter. The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders, and if the customer does not object, then the member may reasonably conclude that the customer has consented and may rely on the letter. In addition, a member may provide clear and comprehensive oral disclosure to, and obtain consent from, the customer on an order-by-order basis, provided the member documents who provided the consent and such consent evidences the customer's understanding of the terms and conditions for handling the customer's order.

The third, and final, category of permitted transactions is addressed in Supplementary Material .04(c) and concerns transactions that are executed, in whole or in

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13 See NASD Notice to Members 05-51 (August 2005); NASD Notice to Members 97-57 (September 1997). Hedging and positioning activity around a customer block order was discussed in coordinated guidance published by both NASD and NYSE in 2005 with respect to volume-weighted average price transactions. See NASD Notice to Members 05-51 (August 2005); NYSE Information Memo 05-52 (August 2005).

14 These transactions may include, for example, hedging or other positioning activity undertaken in connection with the handling of the customer order.

part, on a national securities exchange and comply with the marketplace rules of that exchange. This provision, which is being proposed in response to comments received from exchanges, states that the prohibitions in Rule 5270 shall not apply if the member's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.[15] This provision recognizes that it is not FINRA's intent to introduce conflicts with other existing SRO rules.

Finally, FINRA is proposing to adopt Supplementary Material .05 to the rule to reiterate that the front running of any customer order, not just imminent block transactions, that places the financial interests of the member ahead of those of its customer or the misuse of knowledge of an imminent customer order may violate other FINRA rules, including FINRA Rules 2010 and 5320, or the federal securities laws.[16]

As noted above, FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The implementation date will be no later than 90 days following publication of the Regulatory Notice announcing Commission approval.

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15 See infra note 20.

16 Although "not held" orders are not subject to the restrictions in FINRA Rule 5320, front running a "not held" order that is not of block size may nonetheless violate FINRA Rule 2010. See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011). If the "not held" order is of block size, the proposed rule change would apply to trading activity ahead of the order.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[17] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change clarifies the types of front running trading activity that FINRA believes are inconsistent with just and equitable principles of trade while also ensuring that members may continue to engage in transactions that do not present the risk of abusive trading practices that the rule is intended to prevent. FINRA believes that expanding the terms of the rule beyond options and security futures will enhance the protection of customer orders by addressing more directly within the rule other types of abusive trading that may be intended to take advantage of customer orders. By broadening the scope of prohibited trading activity addressed in the rule, FINRA believes that imminent customer block orders will be better protected and that the proposed rule change will prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and better protect investors and the public interest.

The proposed rule change also specifically identifies three categories of trading activity that are permitted so that the expanded rule will not hamper legitimate trading activity to the detriment of customers, firms, or the market: transactions that the member can demonstrate are unrelated to the customer block order, transactions that are undertaken to fulfill or facilitate the execution of the customer block order, and transactions that are executed, in whole or in part, on a national securities exchange and

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[17] 15 U.S.C. 78o–3(b)(6).

comply with the marketplace rules of that exchange. FINRA believes that permitting the trading activity in each of these three categories is consistent with promoting just and equitable principles of trade and protecting investors and the public interest and will not result in fraudulent and manipulative acts and practices. As discussed in Section (a), FINRA believes that transactions that the member can demonstrate are unrelated to the customer block order do not present the potential for abusive trading practices that can disadvantage a customer's order in violation of the rule. FINRA believes that transactions that are undertaken to fulfill or facilitate the execution of the customer block order similarly do not present the potential for abuse the rule is designed to prohibit but also will allow trading activity that can enhance the execution of a customer block order, thus promoting just and equitable principles of trade and protecting investors. Finally, FINRA believes that permitting transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange is consistent with Section 15A(b)(6) of the Act.[18] The marketplace rules of the exchanges that may otherwise conflict with the proposed rule change have been approved by the Commission and found consistent with the Act. Consequently, FINRA believes it promotes just and equitable principles of trade to permit specific trading activity allowed under other approved SRO rules that would otherwise be brought within the broader prohibitions of the proposed rule change.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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[18] 15 U.S.C. 78o–3(b)(6).

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 08-83 (December 2008). FINRA received three comment letters in response to the Regulatory Notice.[19] A copy of Regulatory Notice 08-83 is attached as Exhibit 2a. A list of the comment letters received in response to Regulatory Notice 08-83 is attached as Exhibit 2b. Copies of the comment letters received in response to Regulatory Notice 08-83 are attached as Exhibit 2c.

One commenter, NYSER, agreed with FINRA's proposals in Regulatory Notice 08-83 to broaden the scope of the rule by extending the prohibitions to include trading in the same security as well as other derivative securities and to add a consent provision for certain hedging or positioning activities in relation to a customer order. However, NYSER requested clarification on when information becomes "publicly available" under the proposed rule. Specifically, NYSER wanted clarification regarding whether the proposed rule was intended to apply to trading activity conducted in compliance with certain NYSE, NYSE Arca, and NYSE Amex rules that permit trading based on information related to imminent block transactions when the information has not yet been disseminated via a last sale reporting system but, rather, has entered the market in other ways (e.g., through gapped quotes or disclosure to a trading crowd in the context of

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19 Letter from International Association of Small Broker-Dealers and Advisors ("IASBDA"), dated January 16, 2009; Letter from Securities Industry and Financial Markets Association ("SIFMA"), dated February 27, 2009; Letter from NYSE Regulation, Inc. ("NYSER"), dated July 22, 2009.

anticipatory hedging with respect to options, which is permitted by rule by the options exchanges).[20]

By extending the front running prohibitions to explicitly cover types of securities other than options and security futures, FINRA intends to make clear that misusing material, non-public market information concerning an imminent customer block order is impermissible, regardless of the type of security that is the subject of the order and/or the front running transaction. It is not FINRA's intent to prohibit legitimate trading activity or to supersede other existing SRO rules. Consequently, FINRA has amended the proposed rule change and added a paragraph to the Supplementary Material regarding permitted transactions to clarify that trading will not violate FINRA Rule 5270 if such trading activity is permitted pursuant to the rules of an exchange and at least one leg of the transaction is executed on that exchange.

In its comment letter, SIFMA raises a number of concerns regarding the proposed changes. First, SIFMA opposes the proposed expansion of the rule beyond equity securities or to non-publicly-reported block trades because of the attenuated opportunity for firms to inappropriately benefit from the trade, absent dissemination, and the practical issues of when knowledge of a non-reported block trade is "stale and obsolete." FINRA disagrees and believes that the front running rule should be broadened to include all securities, including fixed income securities, and related financial instruments. The primary issue the proposed rule change is designed to address is straightforward: firms should not use their knowledge of imminent block transactions to benefit themselves at

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[20] See NYSE Arca Rules 6.47A, 6.49(b); NYSE Amex Options Rules 934.3NY; 935NY. FINRA notes that other options exchanges also have trading rules that may, in some scenarios, conflict with the proposed rule change. See CBOE Rule 6.9(e).

the expense of their customers. This fundamental obligation applies any time a firm misuses this type of information to gain a benefit, regardless of what specific securities or financial products are at issue. Consequently, FINRA has proposed to make clear that front running concerns are not limited to securities futures and options and encompass the trading of any security or related financial instrument under the circumstances outlined in the rule.

FINRA recognizes, however, that because the terms of the front running rule are broad, it could capture trading activity that should otherwise be permitted. To balance this expansion, FINRA is also proposing Supplementary Material .04 that lays out the types of trading activity that would not violate the rule and would be permissible.[21] The sole purpose of Supplementary Material .04 is to ensure that appropriate trading activity not be prohibited by the breadth of the rule. In response to comments by SIFMA, FINRA has modified portions of proposed Supplementary Material .04 as discussed above.[22]

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[21] As noted above, Supplementary Material .04 would replace the existing provisions in the Front Running Policy regarding exceptions for transactions executed in automatic execution systems and positioning activity when a member receives an order of block size relating to both an option or security future and the underlying security. Similarly, FINRA had proposed in its Regulatory Notice an exception for riskless principal trades; however, this exception is not separately included as it would fall within the scope of Supplementary Material .04. FINRA believes that proposed Supplementary Material .04 covers permissible trading activity under the proposed rule change. Any trading activity that falls within the current exceptions in the Front Running Policy would need to meet one of the exceptions in the proposed Supplementary Material in order to be excepted from the rule. See SIFMA.

[22] In addition to the modifications discussed above, FINRA has removed the general exception for "'black box' orders where the member has no actual knowledge that the customer order has been routed for execution," which was proposed as part of Supplementary Material .04 in Regulatory Notice 08-83. As discussed above in footnote 11, automated systems may serve as a means by which orders are handled and information regarding those orders is unavailable to other trading units; however, FINRA believes that the use of an automated system should not

SIFMA also requested that FINRA provide guidance and/or objective standards concerning the scope of the term "related financial instrument." For example, SIFMA suggested a rebuttable presumption with a more objective standard with respect to basket and index transactions and noted that some financial instruments, such as variable swaps and volatility swaps, are "marginally linked to equity securities" and are "sufficiently complex" that it is "virtually impossible" to determine on a trade-by-trade basis whether they would be considered to be "related financial instruments."

The proposed rule change defines a "related financial instrument" as "any option, derivative, security-based swap, 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." FINRA believes that the materiality standard used in the proposed rule is a common and well-understood standard in the securities industry. FINRA acknowledges SIFMA's concerns about the increasing variety of financial products and the complex nature of the relationships across products. It is for that exact reason that FINRA believes a materiality standard is appropriate and necessary in the context of the front running rule to ensure each instrument and its impact across products is properly reviewed by members and evaluated with respect to the potential for front running. FINRA also notes that the proposed rule change would extend only to those swaps that are security-based swaps.

SIFMA also commented on the continued use of the term "block transaction" in the proposed rule and recommended that FINRA replace the definition of "block

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permit trading by those persons who may know the terms of the order placed into the automated system.

transaction" and focus instead on "material transactions." FINRA believes that the definition of "block transaction," coupled with the proposed new supplementary material regarding non-block transactions, is sufficiently fluid to capture the appropriate transactions. The definition of "block transaction" makes clear that the 10,000-share threshold is not a strict standard and that transactions involving fewer shares could be considered a block transaction; moreover, a transaction more than 10,000 shares is only "generally" deemed to be a block transaction for purposes of the rule. The addition of Supplementary Material .05 also clarifies that the front running of other types of orders that may not be "imminent block transactions" may nonetheless be considered conduct inconsistent with just and equitable principles of trade and may violate other FINRA rules or provisions of the federal securities laws because such transactions may have violated the animating purpose of the rule that firms should not use their knowledge of imminent customer orders to benefit themselves.

SIFMA also suggested amending the definition of "customer" for purposes of the rule to exclude other institutions, such as banks and unregistered affiliates of broker-dealers. SIFMA's underlying concern is that a disclosure-based approach in the trading of OTC equity derivatives is more appropriate given that the counter-parties in such transactions are generally sophisticated institutional investors who are, nonetheless, included in the general FINRA definition of "customer" since such investors are not broker-dealers.[23] As an initial matter, FINRA believes that the amendment suggested by SIFMA to exclude banks, branches of foreign banks, or unregistered affiliates of a broker-dealer from the definition of "customer" for purposes of the rule is too broad. To

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[23] See FINRA Rule 0160(b)(4).

exclude sophisticated institutional investors from the definition of "customer" is inappropriate given the use of the term throughout the rule for provisions that should include all customers, including sophisticated investors (e.g., prohibiting a member or an associated person of the member from providing material, non-public market information to "customers" to allow them to trade on the information). To address SIFMA's underlying concern regarding the proposed rule change's potential impact on the trading of OTC equity derivatives, FINRA notes that Supplementary Material .04 recognizes that certain trading can be affected provided the firm has received its customer's consent, which can be through negative consent.

Two commenters also requested that FINRA provide guidance on the knowledge standard in Supplementary Material .01, which provides that the violative practices set forth in the rule "may include transactions 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."[24] This provision, which remains substantively the same as the current standard in the Front Running Policy, is intended to make clear that a member need not know every detail of a potential block order for the front running prohibitions to attach. As SIFMA noted, FINRA has provided guidance in the past in the context of volume-weighted average price transactions. For example, in NASD Notice to Members 05-51, FINRA stated that a duty to refrain from trading may exist "before a member is awarded an order for execution [and] will turn on, among other factors, the type of order and the specifics of the order known by the member," which may include the security, the size of the order, the side of the market, the weighting of a basket order, and the timing for completion of

[24] See IASBDA, SIFMA.

the order. As this guidance recognizes, exactly when the front running prohibitions may attach depends upon the facts and circumstances of the communications between the member and its customer.

Finally, SIFMA commented on the proposed rule change's potential effects on the trading of OTC equity derivatives. SIFMA believes the proposed rule change will require firms to substantially reorganize their OTC equity derivatives operations to set up unwarranted information barriers to accommodate their trading, given that customer-facing OTC equity derivatives trading desks can be the same desks that manage the risk of the firm's overall OTC equity derivatives book. SIFMA asserts that the current regime of disclosure to sophisticated customers and counterparties works well for OTC equity derivatives (e.g., ISDA Master Agreements). FINRA does not believe that the proposed rule change would necessitate the imposition of unwarranted information barriers. FINRA believes that the provisions regarding permitted transactions in proposed Supplementary Material .04, as amended from the form proposed in Regulatory Notice 08-83 in response to comments, are broad enough to exclude appropriate trading activity from the scope of the rule, including trading activity that the member can demonstrate is unrelated to the material, non-public market information received in connection with an imminent customer block order.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[25]

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[25] 15 U.S.C. 78s(b)(2).

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 08-83 (December 2008).

Exhibit 2b. List of commenters.

Exhibit 2c. Comments received in response to Regulatory Notice 08-83.

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2012-025)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 5270 (Front Running of Block Transactions) in the Consolidated FINRA Rulebook

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt NASD Interpretive Material ("IM") 2110-3 (Front Running Policy) as FINRA Rule 5270 with the changes described below.

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[3] FINRA is proposing to adopt NASD IM-2110-3 ("Front Running Policy") as FINRA Rule 5270 with the changes described below.

The Front Running Policy, which was adopted as interpretive material to Article III, Section 1 of the NASD's Rules of Fair Practice[4] in 1987,[5] states that it is considered

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3 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 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 Information Notice, March 12, 2008 (Rulebook Consolidation Process).

4 Article III, Section 1 of the NASD's Rules of Fair Practice was subsequently renumbered as NASD Rule 2110, and is now FINRA Rule 2010. See Regulatory Notice 08-57 (October 2008).

5 NASD adopted the Front Running Policy at the same time as several other self-regulatory organizations ("SROs") filed their policies regarding front running of block transactions. See Securities Exchange Act Release No. 25233 (December

conduct inconsistent with just and equitable principles of trade for a member or an associated person of a member to buy or sell security futures or certain options for accounts in which the member or associated person has an interest when the member or associated person has material, non-public market information concerning an imminent block transaction[6] in the underlying security. Similarly, the same prohibition applies in the underlying security when the material, non-public market information regarding a block transaction concerns an option or security future on that underlying security.[7] The Front Running Policy also prohibits providing material, non-public market information concerning an imminent block transaction to customers who then trade on the basis of the information. The Front Running Policy is limited to transactions in equity securities and options that are required to be reported on a last sale reporting system and to any transaction involving a security future, regardless of whether the transaction is reported. The prohibitions apply until the information concerning the block transaction has been made publicly available (i.e., "when [the information] has been disseminated via the tape

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30, 1987), 53 FR 296 (January 6, 1988). See also NASD Notice to Members 87-69 (October 1987).

6 The rule states that "[a] transaction involving 10,000 shares or more of an underlying security, or options or security futures covering 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."

7 The Front Running Policy initially applied only to certain options (either trading the option while in possession of material, non-public market information regarding an imminent block transaction in the underlying security or trading the underlying security while in possession of material, non-public market information regarding an imminent block transaction in the option). In 2002, the rule was broadened to include the same prohibitions with respect to security futures. See Securities Exchange Act Release No. 46663 (October 15, 2002), 67 FR 64944 (October 22, 2002); see also NASD Notice to Members 02-73 (November 2002).

or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Act, an alternative trading system under Regulation ATS, or by a third-party news wire service").

Finally, the Front Running Policy includes exceptions from the general prohibitions in the rule for "transactions executed by member participants in automatic execution systems in those instances where participants must accept automatic executions" as well as situations where a member receives a customer's block order relating to both an option or security future and the underlying security and the member, in furtherance of facilitating the customer's block order, positions the other side of one or both components of the order. In the latter case, a member is still prohibited from covering any resulting proprietary position by entering an offsetting order until information concerning the block transaction has been made publicly available.

FINRA is proposing to adopt IM-2110-3 as FINRA Rule 5270 and amend the rule in several ways to broaden its scope and provide further clarity into activity that FINRA believes is inconsistent with just and equitable principles of trade. First, FINRA is proposing to extend the prohibitions in the rule to apply explicitly to all securities and 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, or otherwise acts as a substitute for, the underlying security. Specifically, FINRA is proposing to extend 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 if the value of the underlying security 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"). The reverse would also be true: when the imminent block transaction itself involves a related financial instrument, the proposed rule would prevent trading in the underlying security. The proposed rule change also extends the trading provisions in the rule to include explicitly trading in the same security or related financial instrument that is the subject of an imminent block transaction.[8]

Although the proposed rule change would broaden the scope of trading covered by the front running rule, FINRA believes that the type of trading prohibited by the proposed rule change would generally already violate other existing FINRA rules, such as FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade). As FINRA noted when it first adopted the Front Running Policy, the adoption of the rule was never intended to imply that other forms of trading activity not explicitly covered by the Front Running Policy could not violate FINRA rules.[9] Because FINRA believes the

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8 The Commission noted in the release seeking comment on the SRO front running rules that, generally, "the SROs define frontrunning as the practice of trading a security while in possession of material, non-public information regarding an imminent block transaction in the same or a related security." See Securities Exchange Act Release No. 25233 (December 30, 1987), 53 FR 296 (January 6, 1988).

9 FINRA has consistently noted that the Front Running Policy does not provide an exhaustive list of prohibited front running trading. See NASD Notice to Members 87-69 (October 1987) ("Although the Board believes it is important to provide guidelines describing the kind of [front running] conduct that will not be permitted, members and persons associated with a member should be aware that any conduct that is not consistent with their fiduciary responsibilities in this area would be a violation of [just and equitable principles of trade]."). See also NASD Notice to Members 96-66 (October 1996) (noting that although the Front Running Policy applied only to equity securities, actions for similar conduct involving government securities would violate just and equitable principles of trade).

Front Running Policy is unduly narrow in capturing the types of front running activity that are inconsistent with just and equitable principles of trade, FINRA is proposing to broaden the language of the Front Running Policy to apply equally to all related financial instruments (e.g., stock options and futures, options futures, other derivatives, and security-based swaps) rather than be limited to equity securities, security futures, and certain options.[10]

As noted above, the trading restrictions imposed by the current Front Running Policy apply until information about the imminent customer block transaction "has been made publicly available," which the rule defines as having been disseminated to the public in trade reporting data. The proposed rule change generally retains this standard for determining when information has become publicly available; however, because FINRA is proposing to expand the rule to include related financial instruments that may not result in publicly available trading information being made available, FINRA is also proposing that the prohibitions in the rule be in place until the material, non-public market information is either publicly available or "otherwise becomes stale or obsolete."[11]

The proposed rule change also replaces several existing provisions in the Front Running Policy with Supplementary Material to FINRA Rule 5270. Specifically, FINRA

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[10] Notwithstanding the amendments discussed in the proposed rule change, FINRA notes that, as amended, the rule is still not intended to provide an exhaustive list of prohibited trading activity. Proposed Supplementary Material .05, for example, states that front running orders not explicitly covered by the terms of Rule 5270 could nonetheless violate other FINRA rules.

[11] Whether information has become stale or obsolete will depend upon the particular facts and circumstances involved, including specific information the member has regarding the transaction, but could include factors such as the amount of time that has passed since the member learned of the block transaction, subsequent trading activity in the security, or a significant change in market conditions.

is proposing to replace 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 receives a customer's block order relating to both an option and the underlying security or a security future and the underlying security with new Supplementary Material that identifies types of transactions that are permitted under the rule.

Under the Supplementary Material, there are three broad categories of permitted transactions: transactions that the member can demonstrate are unrelated to the customer block order, transactions that are undertaken to fulfill or facilitate the execution of the customer block order, and transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange.

The first category of permitted transactions are those that the member can demonstrate are unrelated to the customer block order. Supplementary Material .04(a) recognizes that members may engage in such transactions provided that the member can demonstrate that the transactions are unrelated to the material, non-public market information received in connection with the customer order. The Supplementary Material includes an illustrative list of potentially permitted transactions as examples of transactions that, depending upon the circumstances, may be unrelated to the customer block order. These types of transactions could include transactions where the member has effective information barriers established to prevent internal disclosure of customer order information,[12] transactions in the security that is the subject of the customer block

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[12] In addition to more traditional information barriers, such as those in place to prevent communication between trading units, this provision could also include the use of automated systems (e.g., trades through a "black box") where the orders

order that are related to a prior customer order in that security, transactions to correct bona fide errors, and transactions to offset odd-lot orders.

For each of these types of transactions, the member must be able to demonstrate that the transaction at issue was unrelated to the customer block order. Thus, for example, if the member can demonstrate that transactions occurring in a security (or a related financial instrument) that is the subject of an imminent customer block order were undertaken by a desk that is walled off from the desk handling the customer block order by the use of effective information barriers, the trading activity would be unrelated to the customer block order and, therefore, permitted.[13]

Similarly, FINRA believes that transactions that a member can demonstrate are related to other customer orders in the same security, correct bona fide errors made in earlier transactions involving the security, or offset other odd-lot orders in the security are generally unrelated to the customer block order and therefore should be permitted.

The second category of permitted transactions involve transactions that are undertaken to fulfill or facilitate the execution of the customer block order. FINRA has

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placed into the automated system are handled without the knowledge of a person associated with the member who may be trading in the same security. However, a person associated with a member who places an order into a "black box" or other automated system, or otherwise has knowledge of the order or the ability to access information in the system, may not then trade in the same security or a related financial instrument solely because the order ultimately was being handled by the automated system rather than by the person. Traders who have no knowledge of the order, due to the presence of an information barrier or otherwise, could continue to trade in the security or a related financial instrument. See infra note 23.

13 FINRA believes that this approach is compatible with the existing provisions concerning customer order protection in Rule 5320 and its accompanying Supplementary Material concerning protection of customer limit and market orders and the implementation of effective information barriers.

acknowledged that 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.[14] Supplementary Material .04(b) thus makes clear that Rule 5270 does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, a customer's block order.[15] However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the member must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the member's financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity. The Supplementary Material provides that a member may obtain its customers' consent through affirmative written consent or through means of a negative consent letter. The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders, and if the customer does not object, then the member may reasonably conclude that the customer has consented and may rely on the letter. In addition, a member may provide clear and comprehensive oral disclosure to, and obtain consent from, the customer on an order-by-order basis, provided the member documents who provided the consent and

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14 See NASD Notice to Members 05-51 (August 2005); NASD Notice to Members 97-57 (September 1997). Hedging and positioning activity around a customer block order was discussed in coordinated guidance published by both NASD and NYSE in 2005 with respect to volume-weighted average price transactions. See NASD Notice to Members 05-51 (August 2005); NYSE Information Memo 05-52 (August 2005).

15 These transactions may include, for example, hedging or other positioning activity undertaken in connection with the handling of the customer order.

such consent evidences the customer's understanding of the terms and conditions for handling the customer's order.

The third, and final, category of permitted transactions is addressed in Supplementary Material .04(c) and concerns transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange. This provision, which is being proposed in response to comments received from exchanges, states that the prohibitions in Rule 5270 shall not apply if the member's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.[16] This provision recognizes that it is not FINRA's intent to introduce conflicts with other existing SRO rules.

Finally, FINRA is proposing to adopt Supplementary Material .05 to the rule to reiterate that the front running of any customer order, not just imminent block transactions, that places the financial interests of the member ahead of those of its customer or the misuse of knowledge of an imminent customer order may violate other FINRA rules, including FINRA Rules 2010 and 5320, or the federal securities laws.[17]

FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval.

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16 See infra note 21.

17 Although "not held" orders are not subject to the restrictions in FINRA Rule 5320, front running a "not held" order that is not of block size may nonetheless violate FINRA Rule 2010. See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011). If the "not held" order is of block size, the proposed rule change would apply to trading activity ahead of the order.

The implementation date will be no later than 90 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[18] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change clarifies the types of front running trading activity that FINRA believes are inconsistent with just and equitable principles of trade while also ensuring that members may continue to engage in transactions that do not present the risk of abusive trading practices that the rule is intended to prevent. FINRA believes that expanding the terms of the rule beyond options and security futures will enhance the protection of customer orders by addressing more directly within the rule other types of abusive trading that may be intended to take advantage of customer orders. By broadening the scope of prohibited trading activity addressed in the rule, FINRA believes that imminent customer block orders will be better protected and that the proposed rule change will prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and better protect investors and the public interest.

The proposed rule change also specifically identifies three categories of trading activity that are permitted so that the expanded rule will not hamper legitimate trading activity to the detriment of customers, firms, or the market: transactions that the member can demonstrate are unrelated to the customer block order, transactions that are

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[18] 15 U.S.C. 78o–3(b)(6).

undertaken to fulfill or facilitate the execution of the customer block order, and transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange. FINRA believes that permitting the trading activity in each of these three categories is consistent with promoting just and equitable principles of trade and protecting investors and the public interest and will not result in fraudulent and manipulative acts and practices. As discussed in Section (a), FINRA believes that transactions that the member can demonstrate are unrelated to the customer block order do not present the potential for abusive trading practices that can disadvantage a customer's order in violation of the rule. FINRA believes that transactions that are undertaken to fulfill or facilitate the execution of the customer block order similarly do not present the potential for abuse the rule is designed to prohibit but also will allow trading activity that can enhance the execution of a customer block order, thus promoting just and equitable principles of trade and protecting investors. Finally, FINRA believes that permitting transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange is consistent with Section 15A(b)(6) of the Act.[19] The marketplace rules of the exchanges that may otherwise conflict with the proposed rule change have been approved by the Commission and found consistent with the Act. Consequently, FINRA believes it promotes just and equitable principles of trade to permit specific trading activity allowed under other approved SRO rules that would otherwise be brought within the broader prohibitions of the proposed rule change.

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[19] 15 U.S.C. 78o–3(b)(6).

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 08-83 (December 2008). FINRA received three comment letters in response to the Regulatory Notice.[20] A copy of Regulatory Notice 08-83 is attached as Exhibit 2a. A list of the comment letters received in response to Regulatory Notice 08-83 is attached as Exhibit 2b. Copies of the comment letters received in response to Regulatory Notice 08-83 are attached as Exhibit 2c.

One commenter, NYSER, agreed with FINRA's proposals in Regulatory Notice 08-83 to broaden the scope of the rule by extending the prohibitions to include trading in the same security as well as other derivative securities and to add a consent provision for certain hedging or positioning activities in relation to a customer order. However, NYSER requested clarification on when information becomes "publicly available" under the proposed rule. Specifically, NYSER wanted clarification regarding whether the proposed rule was intended to apply to trading activity conducted in compliance with certain NYSE, NYSE Arca, and NYSE Amex rules that permit trading based on information related to imminent block transactions when the information has not yet been

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[20] Letter from International Association of Small Broker-Dealers and Advisors ("IASBDA"), dated January 16, 2009; Letter from Securities Industry and Financial Markets Association ("SIFMA"), dated February 27, 2009; Letter from NYSE Regulation, Inc. ("NYSER"), dated July 22, 2009.

disseminated via a last sale reporting system but, rather, has entered the market in other ways (e.g., through gapped quotes or disclosure to a trading crowd in the context of anticipatory hedging with respect to options, which is permitted by rule by the options exchanges).[21]

By extending the front running prohibitions to explicitly cover types of securities other than options and security futures, FINRA intends to make clear that misusing material, non-public market information concerning an imminent customer block order is impermissible, regardless of the type of security that is the subject of the order and/or the front running transaction. It is not FINRA's intent to prohibit legitimate trading activity or to supersede other existing SRO rules. Consequently, FINRA has amended the proposed rule change and added a paragraph to the Supplementary Material regarding permitted transactions to clarify that trading will not violate FINRA Rule 5270 if such trading activity is permitted pursuant to the rules of an exchange and at least one leg of the transaction is executed on that exchange.

In its comment letter, SIFMA raises a number of concerns regarding the proposed changes. First, SIFMA opposes the proposed expansion of the rule beyond equity securities or to non-publicly-reported block trades because of the attenuated opportunity for firms to inappropriately benefit from the trade, absent dissemination, and the practical issues of when knowledge of a non-reported block trade is "stale and obsolete." FINRA disagrees and believes that the front running rule should be broadened to include all securities, including fixed income securities, and related financial instruments. The

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21 See NYSE Arca Rules 6.47A, 6.49(b); NYSE Amex Options Rules 934.3NY; 935NY. FINRA notes that other options exchanges also have trading rules that may, in some scenarios, conflict with the proposed rule change. See CBOE Rule 6.9(e).

primary issue the proposed rule change is designed to address is straightforward: firms should not use their knowledge of imminent block transactions to benefit themselves at the expense of their customers. This fundamental obligation applies any time a firm misuses this type of information to gain a benefit, regardless of what specific securities or financial products are at issue. Consequently, FINRA has proposed to make clear that front running concerns are not limited to securities futures and options and encompass the trading of any security or related financial instrument under the circumstances outlined in the rule.

FINRA recognizes, however, that because the terms of the front running rule are broad, it could capture trading activity that should otherwise be permitted. To balance this expansion, FINRA is also proposing Supplementary Material .04 that lays out the types of trading activity that would not violate the rule and would be permissible.[22] The sole purpose of Supplementary Material .04 is to ensure that appropriate trading activity not be prohibited by the breadth of the rule. In response to comments by SIFMA, FINRA has modified portions of proposed Supplementary Material .04 as discussed above.[23]

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22 As noted above, Supplementary Material .04 would replace the existing provisions in the Front Running Policy regarding exceptions for transactions executed in automatic execution systems and positioning activity when a member receives an order of block size relating to both an option or security future and the underlying security. Similarly, FINRA had proposed in its Regulatory Notice an exception for riskless principal trades; however, this exception is not separately included as it would fall within the scope of Supplementary Material .04. FINRA believes that proposed Supplementary Material .04 covers permissible trading activity under the proposed rule change. Any trading activity that falls within the current exceptions in the Front Running Policy would need to meet one of the exceptions in the proposed Supplementary Material in order to be excepted from the rule. See SIFMA.

23 In addition to the modifications discussed above, FINRA has removed the general exception for "'black box' orders where the member has no actual knowledge that the customer order has been routed for execution," which was proposed as part of

SIFMA also requested that FINRA provide guidance and/or objective standards concerning the scope of the term "related financial instrument." For example, SIFMA suggested a rebuttable presumption with a more objective standard with respect to basket and index transactions and noted that some financial instruments, such as variable swaps and volatility swaps, are "marginally linked to equity securities" and are "sufficiently complex" that it is "virtually impossible" to determine on a trade-by-trade basis whether they would be considered to be "related financial instruments."

The proposed rule change defines a "related financial instrument" as "any option, derivative, security-based swap, 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." FINRA believes that the materiality standard used in the proposed rule is a common and well-understood standard in the securities industry. FINRA acknowledges SIFMA's concerns about the increasing variety of financial products and the complex nature of the relationships across products. It is for that exact reason that FINRA believes a materiality standard is appropriate and necessary in the context of the front running rule to ensure each instrument and its impact across products is properly reviewed by members and evaluated with respect to the potential for front running. FINRA also notes that the proposed rule change would extend only to those swaps that are security-based swaps.

Supplementary Material .04 in Regulatory Notice 08-83. As discussed above in footnote 12, automated systems may serve as a means by which orders are handled and information regarding those orders is unavailable to other trading units; however, FINRA believes that the use of an automated system should not permit trading by those persons who may know the terms of the order placed into the automated system.

SIFMA also commented on the continued use of the term "block transaction" in the proposed rule and recommended that FINRA replace the definition of "block transaction" and focus instead on "material transactions." FINRA believes that the definition of "block transaction," coupled with the proposed new supplementary material regarding non-block transactions, is sufficiently fluid to capture the appropriate transactions. The definition of "block transaction" makes clear that the 10,000-share threshold is not a strict standard and that transactions involving fewer shares could be considered a block transaction; moreover, a transaction more than 10,000 shares is only "generally" deemed to be a block transaction for purposes of the rule. The addition of Supplementary Material .05 also clarifies that the front running of other types of orders that may not be "imminent block transactions" may nonetheless be considered conduct inconsistent with just and equitable principles of trade and may violate other FINRA rules or provisions of the federal securities laws because such transactions may have violated the animating purpose of the rule that firms should not use their knowledge of imminent customer orders to benefit themselves.

SIFMA also suggested amending the definition of "customer" for purposes of the rule to exclude other institutions, such as banks and unregistered affiliates of broker-dealers. SIFMA's underlying concern is that a disclosure-based approach in the trading of OTC equity derivatives is more appropriate given that the counter-parties in such transactions are generally sophisticated institutional investors who are, nonetheless, included in the general FINRA definition of "customer" since such investors are not broker-dealers.[24] As an initial matter, FINRA believes that the amendment suggested by

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[24] See FINRA Rule 0160(b)(4).

SIFMA to exclude banks, branches of foreign banks, or unregistered affiliates of a broker-dealer from the definition of "customer" for purposes of the rule is too broad. To exclude sophisticated institutional investors from the definition of "customer" is inappropriate given the use of the term throughout the rule for provisions that should include all customers, including sophisticated investors (e.g., prohibiting a member or an associated person of the member from providing material, non-public market information to "customers" to allow them to trade on the information). To address SIFMA's underlying concern regarding the proposed rule change's potential impact on the trading of OTC equity derivatives, FINRA notes that Supplementary Material .04 recognizes that certain trading can be affected provided the firm has received its customer's consent, which can be through negative consent.

Two commenters also requested that FINRA provide guidance on the knowledge standard in Supplementary Material .01, which provides that the violative practices set forth in the rule "may include transactions 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."[25] This provision, which remains substantively the same as the current standard in the Front Running Policy, is intended to make clear that a member need not know every detail of a potential block order for the front running prohibitions to attach. As SIFMA noted, FINRA has provided guidance in the past in the context of volume-weighted average price transactions. For example, in NASD Notice to Members 05-51, FINRA stated that a duty to refrain from trading may exist "before a member is awarded an order for

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[25] See IASBDA, SIFMA.

execution [and] will turn on, among other factors, the type of order and the specifics of the order known by the member," which may include the security, the size of the order, the side of the market, the weighting of a basket order, and the timing for completion of the order. As this guidance recognizes, exactly when the front running prohibitions may attach depends upon the facts and circumstances of the communications between the member and its customer.

Finally, SIFMA commented on the proposed rule change's potential effects on the trading of OTC equity derivatives. SIFMA believes the proposed rule change will require firms to substantially reorganize their OTC equity derivatives operations to set up unwarranted information barriers to accommodate their trading, given that customer-facing OTC equity derivatives trading desks can be the same desks that manage the risk of the firm's overall OTC equity derivatives book. SIFMA asserts that the current regime of disclosure to sophisticated customers and counterparties works well for OTC equity derivatives (e.g., ISDA Master Agreements). FINRA does not believe that the proposed rule change would necessitate the imposition of unwarranted information barriers. FINRA believes that the provisions regarding permitted transactions in proposed Supplementary Material .04, as amended from the form proposed in Regulatory Notice 08-83 in response to comments, are broad enough to exclude appropriate trading activity from the scope of the rule, including trading activity that the member can demonstrate is unrelated to the material, non-public market information received in connection with an imminent customer block order.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2012-025 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2012-025. This file number should be included on the subject line if e-mail is used. To help the Commission process

and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2012-025 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[26]

Elizabeth M. Murphy

Secretary

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[26] 17 CFR 200.30-3(a)(12).

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

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.

EXHIBIT 2b

Alphabetical List of Written Comments

1. Peter J. Chepucavage, Plexus Consulting LLC (January 21, 2009)

2. James F. Duffy, NYSE Regulation (July 22, 2009)

3. Ann Vlcek and Gerard J. Quinn, Securities Industry and Financial Markets Association (February 27, 2009)

The International Association of Small Broker Dealers and Advisors

1620 Eye Street, NW, Suite 210 Washington, DC 20006

202-785-8940 ext. 108

pchepucavage@plexusconsulting.com

www.iasbda.com

The International Association of Small Broker-Dealers and Advisers www.iasbda.com submits the following comment on one important aspect of the above referenced rule. We believe that the discussion of **knowledge of block transactions** could be significantly expanded/clarified. The pertinent text is included below. We believe it is well accepted that this applies when the transaction is being effected by one's own firm. However it has always been unclear as to how it applies when the knowledge is of another firm's transaction. Thus when a trading desk receives an inquiry about a block of stock, we believe that is not enough to prohibit a trade of the same securities. We can envision circumstances when a trader receives enough information to trigger this restriction but a simple inquiry would not do so.Thus the commentary on the rule could make this very clear without denigrating its original purpose.

Front running can also occur with firm research and we believe there is one other aspect of it that should be covered.Hedge funds have been accused of trading ahead of broker dealer research reports in return for commission business. We believe it would be a good time for FINRA to further explore this issue and make clear its position on it. While its clear that the bd cannot trade ahead of its own report(See FINRA - SR-FINRA-2008-054) we believe that all of its customers and potential customers should also be so prohibited and that all customers and potential customers should get the report at the same time. Whether the public should simultaneously get it, should be explored and addressed.

Finally, there is a recurring suggestion in the news that the Madoff customers believed they were getting something special from his market maker status. If no one at the firm was checking the discretionary account business how could they or the examiners be sure there were no front running conflicts? There is therefore a compelling reason for FINRA to examine this entire area of favored status to insure that everyone understands who can and cannot be favored and what more specifically is knowledge of a block transaction or an upcoming research report.

.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 participantsmust accept automatic executions.]

[These prohibitions also do not include situations in which amember 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 amembermay position the other side of one or both components of the order. However, in these instances, the member and person associated with amember 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

Peter J.Chepucavage
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Plexus Consulting LLC
1620 I ST. N.W.
Washington,D.C.20006
202-785-8940 ex 108

James F. Duffy
Interim Chief Executive Officer
NYSE Regulation, Inc.

NYSE Regulation

NYSE Regulation, Inc. | 11 Wall Street
New York, New York 10005
t 212.656-5855 | f 212-656-5809
jduffy@nyx.com

Office of the Corporate Secretary-Admin.

Via email and First-Class Mail

JUL 28 2009

July 22, 2009

FINRA
Notice to Members

Thomas Gira
Executive Vice President
FINRA
9509 Key West Avenue
Rockville, MD 20850-3329
Tom.Gira@finra.org

Re: Proposed FINRA Rule Regarding Front Running of Block Transactions; FINRA Regulatory Notice 08-83 (December 2008)

Dear Tom:

This letter is intended to memorialize the views of NYSE Regulation, Inc. ("NYSE Regulation") regarding the scope of the proposal set forth in the above referenced FINRA Regulatory Notice. NYSE Regulation shares FINRA's concerns regarding front running trading activity, and the New York Stock Exchange LLC ("NYSE"), NYSE Arca, Inc. ("NYSE Arca"), and NYSE Amex LLC ("NYSE Amex") each have had longstanding rules and/or interpretations barring front running activities.[1] Moreover, NYSE Regulation agrees with FINRA's determination to broaden the scope of NASD IM-2110-3, which is FINRA's current front running rule, to (i) extend the prohibitions of the rule to include trading in the same security that is the subject of an imminent block transaction as well as to other derivative securities, and (ii) add an affirmative consent provision for certain hedging or positioning activities in relation to a customer order.

However, NYSE Regulation seeks clarification that proposed FINRA Rule 5270 is not intended to apply to trading activity conducted in compliance with certain NYSE, NYSE Arca, or NYSE Amex trading rules. In particular, when in possession of what FINRA

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1 See NYSE Information Memos 89-53 (Nov. 27, 1989), 88-9 (Apr. 13, 1988), 85-36 (Nov. 6, 1985), and 80-38 (Sept. 11, 1980); NYSE Arca Rule 11.6; Amex Rules 24, 111.03(c), and 950(d).04; and Amex Information Circulars 79-12, 80-36, 82-37, 85-115, and 90-147.

may consider to be material, non-public market information concerning an imminent block transaction, proposed FINRA Rule 5270 bars trading in related financial instruments until such time that information about the block transaction has been made publicly available or has otherwise become stale or obsolete. Under the proposed rule, information about a block transaction is considered publicly available only after it is has been disseminated via a last-sale reporting system. The proposed rule further permits certain hedging and positioning activity based on knowledge of an imminent block transaction provided that the customer has provided prior affirmative written consent.

Notwithstanding FINRA's proposed definition of when information about an imminent block transaction becomes publicly available, and thus when trading based on such information is permissible, certain equities and options trading rules permit trading based on information relating to imminent block transactions before such transactions have been reported to last-sale reporting system. These rules require certain disclosures and/or handling procedures about the imminent block transaction before trading on such information can occur, which ensures that the information traded upon is publicly available. However, such public dissemination is not necessarily via a last-sale reporting system.

For example, on the equities markets, to minimize any possible short-term price dislocation, NYSE and NYSE Amex Equities Designated Market Makers ("DMM") can publicly disseminate, via the Consolidated Tape, a gapped quote if a block-sized order imbalance exists in a particular security. The gapped quote allows time for the entry of offsetting orders, or the cancellation of orders on the side of the imbalance. The imbalance that can trigger the gap quote policy may occur when the DMM receives a sudden influx of orders on the same side of the market at the same time, or when there are one or more large-size orders and there is insufficient offsetting interest. The existence of a gapped quote alerts the trading public of a possible block-sized order for the very purpose of attracting contra-side liquidity. NYSE Regulation seeks clarification that under FINRA's proposed frontrunning rule, because the material terms of the trade that may result from the gapped quote are not yet known, the gapped quote in of itself does not constitute a non-public imminent block transaction. NYSE Regulation seeks further clarification that dissemination of information that alerts the trading public to the possibility of a block-sized order, and any resulting trades based on knowledge of a gapped quote, would not constitute a violation of FINRA's proposed Rule 5270.

The options exchanges also have rules that permit trading based on knowledge of orders, provided that required rule-based disclosures relating to those orders are met before trading occurs. For example, all options exchanges, including NYSE Arca and NYSE Amex, have rules governing anticipatory hedging.[2] These rules prohibit a member (or

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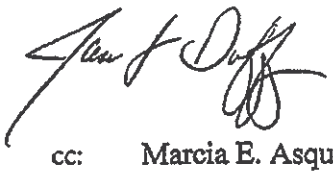
[2] See, e.g., NYSE Arca Rules 6.47A and 6.49(b) and NYSE Amex Options Rules 934.3NY and 935NY.

person associated with a member), who has knowledge of all material terms and conditions of (i) an originating order and a solicited order, (ii) an order being facilitated, or (iii) orders being crossed, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option of the same class as any option that is the subject of the order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (i) all the terms of the originating order and any changes in the terms and conditions of the order of which that member or associated person has knowledge are disclosed to the trading crowd or (ii) the trade can no longer reasonably be considered imminent in view of the passage of time since the order was received. In contrast to FINRA's proposed Rule 5270, these rules permit anticipatory hedging once the terms of the order are disclosed to the trading crowd, rather than requiring that information regarding completion of the block transaction has been made publicly available via a last-sale reporting system. Accordingly, NYSE Regulation recommends that FINRA should revise its proposed Rule 5270 to clarify that trading conducted pursuant to the requirements of these and comparable anticipatory hedging rules would not be violative.

* * *

If you have any questions regarding the foregoing, please feel free to contact Claudia Crowley, Senior Vice President, NYSE Regulation, at (212) 656-4631 or Clare Saperstein, Managing Director, NYSE Regulation, at (212) 656-2355.

Sincerely yours,



cc: Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506 (by first-class mail only)

February 27, 2009

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

Re: FINRA Regulatory Notice 08-83: Front Running of Block Transactions

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association[1] ("SIFMA") appreciates the opportunity to comment on Regulatory Notice 08-83, which proposes to amend FINRA's Front Running Policy in NASD Interpretive Material ("IM") 2110-3 ("Front Running Policy"). The proposal would codify the amended Front Running Policy in new Rule 5270 and related Supplementary Material and would significantly broaden the scope of transactions subject to the rule beyond equities, options and security futures to also include other derivatives, financial instruments and financial contracts. Given the significance and scope of the proposed changes, we appreciate that FINRA determined to seek comment from member firms before the proposal is submitted to the Securities and Exchange Commission ("SEC") for public notice and comment.

Before providing our specific comments on proposed Rule 5270 and its Supplementary Material, we have certain fundamental concerns related to the proposed expansion of the Front Running Policy. First, we question the need to extend the application of the Policy beyond trading associated with publicly reported block trades.[2] Historically, front running regulation has been designed to capture instances in which firms inappropriately use material non-public

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] In commenting on the proposal, this letter refers to "block transactions" or "block trades" in several instances. However, as noted in Section I.C below, SIFMA recommends that FINRA move away from the use of these terms as the threshold for application of the Front Running Policy in favor of a more appropriate threshold of "material transactions" that might vary depending on the characteristics of particular securities.

market information[3] concerning an imminent block trade by a customer in a listed security in order to benefit from the market movement likely to result from public dissemination of the transaction. Proposed Rule 5270 covers a much broader range of products and situations than prior front running regulation and appears to introduce a significant amount of subjectivity to the application of the rule, while limiting the ability of firms to use available techniques to provide customers with the best pricing menu for over-the-counter ("OTC") products. In particular, the proposed rule covers instances involving imminent block trades involving a "related financial instrument" that is not publicly reported. Market impact with respect to such OTC transactions is not generally direct and therefore at times not fully observable. There will be a host of practical issues facing firms under the proposed rule related to determining when information regarding a non-reported block trade is "stale and obsolete" such that normal trading operations may recommence without violating the rule. Given these difficulties and their associated regulatory risks on the one hand, and the attenuated opportunity for firms to inappropriately benefit from market impact absent public dissemination of a block transaction, FINRA should limit the application of its Front Running Policy to circumstances in which a block trade involves a publicly reported security.

Second, we also are concerned that broad expansion of the Front Running Policy will have unintended, adverse consequences on the trading of OTC equity derivatives. As you know, broker-dealers, either directly or through an affiliated entity, engaging in OTC equity derivatives transactions largely do so as principal rather than as agent, committing their own capital to such transactions. These transactions involve sophisticated counterparties and are extensively documented using the documentation architecture published by the International Swaps and Derivatives Association ("ISDA"), comprising Master Agreements, standard form confirmations, and definitional booklets. These documents include, among other disclosures, discussions of the capacity of the parties (principal counterparties, not fiduciaries), non-reliance of either party on the other, and agreements and acknowledgements regarding the extent to which hedging may or may not occur in connection with a transaction. ISDA agreements also spell out that each counterparty (and/or its affiliates) may have banking or other commercial relationships with an issuer of securities involved in a transaction and may also engage in proprietary trading in such securities or any related instruments, and that such trading may affect the price of securities that are the subject of the agreement.[4] Thus, today, the OTC equity derivatives market operates well, governed primarily by a disclosure-based regime among sophisticated counterparties.[5]

The proposed Front Running Policy should be modified to preserve the ability of firms and sophisticated counterparties to engage in OTC equity derivatives transactions using this disclosure-based approach. As proposed, Rule 5270 would require a firm engaged in OTC

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[3] As discussed below, with one exception in the proposal, the term "material non-public market information" is used throughout the current and proposed Front Running Policy. To avoid confusion, we believe FINRA should refer to "material non-public *market* information" throughout the rule. *See* Section IV.B.

[4] *See* Section 13.4 of the 2002 ISDA Equity Derivatives Definitions.

[5] We appreciate the recent concerns expressed in the press and by certain regulators and members of Congress regarding oversight of the credit derivatives market. We are not aware, however, of significant problems with respect to front running in OTC equity derivatives.

equity derivatives transactions to demonstrate that other trading at or around the same time of a derivatives transaction was unrelated to material non-public market information received in connection with a counterparty's order, or that the firm was engaged in bona fide hedging unrelated to such information for which the counterparty provided affirmative written consent and under circumstances where an information barrier was in place to prevent the disclosure of such information. As a practical matter, given the scope of trading activities conducted by many firms and the limitations of the hedging exemption, we believe that the proposed rule will cause a significant number of firms to substantially reorganize their operations to impose an unwarranted number of information barriers throughout their organization to accommodate their OTC equity derivatives trading.[6] Alternatively, firms may be less willing to commit capital to such trading. Either result would, in our view, be unfortunate and unwarranted given that the disclosure provided in connection with OTC equity derivatives trades has served both dealers and counterparties well. Proposed Rule 5270 should clearly indicate that trading associated with OTC equity derivative transactions does not violate the rule provided that there is adequate disclosure of the material terms of the transaction between counterparties – including, without limitation, disclosure of any anticipatory, proprietary or other trading that may occur at or around the time of the derivatives transaction.[7] Such an approach would be consistent with other instances in which SROs have recognized the sufficiency of disclosure to customers of a firm's principal trading activities.[8] We note that, pursuant to Rule 2110, FINRA has the ability to address particularly egregious trading – such as intentional misconduct or a pattern of abusive trading by a firm with respect to an account – as inconsistent with just and equitable principles of trade.

Third, we respectfully request that instead of evaluating proposed Rule 5270 in isolation, FINRA should consider this rule in conjunction with analogous NYSE, FINRA and other SRO order handling rules and seek to harmonize the rules where appropriate. For example, FINRA should harmonize common elements of FINRA IM 2110-2 ("Manning Rule"), NYSE Rule 92, and related guidance pertaining to member obligations when handling volume-weighted average priced ("VWAP") and other large orders.[9] Although each of these regulations vary, at their core they are all directed at essentially the same conduct: the obligations of firms to apprise customers of how their orders will be handled and to handle such orders fairly. The rules currently require differing levels of disclosure to or consent from customers,[10] and permit divergent types of

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[6] Trading desks that execute OTC equity derivatives on a principal basis with customers and counterparties are the same desks that manage the risk of the firm's overall book of OTC equity derivatives transactions. To comply with the information barriers as drafted in the Supplementary Material would require, in the extreme, an information barrier around each member of the trading desk, which would interfere with effective risk management of the firm's exposures.

[7] As noted, ISDA Master Agreement documentation should suffice for purposes of such disclosure.

[8] *See*, NYSE Information Memo 05-52 (Aug. 1, 2005).

[9] *See*, NYSE Information Memo 05-52 (Aug. 1, 2005) and NASD NTM 05-51 (Aug. 2005).

[10] For example, FINRA interpretive guidance requires an "affirmative consent letter" be delivered on an annual basis in connection with anticipatory hedging of VWAP trades and in connection with blind bid requests, while the NYSE permits a periodic, disclosure-based standard via written notice.

trading by firms.[11] In addition, most of the other SROs have their own front running, trading ahead and hedging regulations similar to those of FINRA, but with some differences.[12] While differing standards may make sense in some instances, such as with respect to how the rule should apply in the context of OTC equity derivatives transactions as discussed above, we believe that the only workable approach, considering the integration of the markets, evolving market structure, cross-asset class trading, and the need to develop well-considered and consistent regulations, is for the SROs to work together to formulate common trading regulations.[13]

In this regard, we recommend that FINRA focus on opportunities to harmonize (i) the knowledge requirement, (ii) permissible hedging and trading activities, (iii) when information is deemed "publicly available," and (iv) disclosure/consent requirements applicable to each regulation. In doing so, FINRA would receive the benefit of more informed comment on the harmonization of these rules by addressing them together rather than singly. Such an approach will result in more efficient and better regulations. We also understand that FINRA plans to discuss the proposed Front Running Policy with members of the Intermarket Surveillance Group ("ISG") and we commend FINRA for these necessary efforts. More frequent consultation of this type often yields greater benefits to SROs, firms and investors.

While we believe that the views noted above regarding fundamental aspects of FINRA's proposal are the most critical to address with any new front running regulations, we recognize that this writing may be our only opportunity to comment on other aspects of the proposed rule prior to FINRA filing the proposal with the SEC. Therefore, the following paragraphs set forth our specific comments on proposed Rule 5270 and its related Supplementary Material.

I. Clarifying the Scope of FINRA's Proposal

A. The Scope of the Proposal Should Be Limited to Equities and Equity-Related Financial Instruments

Proposed Rule 5270 would prohibit member firms and their associated persons from causing the execution, for their own account or for an account for which they exercise investment discretion, of an order to buy or sell *a security* or a related financial instrument when the member or associated person has material non-public market information concerning an imminent block transaction in that *security*, a related financial instrument, or a security

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[11] Compare the broader scope of permissible trading by firms that negotiate terms and conditions governing the handling of orders of institutional customers under the Manning Rule with the more narrow and specific trading exceptions set forth in NYSE Rule 92.

[12] *See, e.g.*, NYSE Arca Rule 6.6, CBOE Rule 6.9(e), CBOE Regulatory Circular 99-224 (Dec. 7, 1999), PHLX Rule 1064, PHLX Rule E6, PHLX Rule F6, and ISE Rule 400. We also understand that the CBOE currently is considering a new rule proposal related to hedging stock in connection with options trades.

[13] FINRA has stressed the importance of "not only picking the best of the NASD and NYSE rulebooks, but ... also going through a very deliberative process to determine if there might be a better way to address regulatory concerns than simply picking between two existing rules." Mary L. Schapiro, Chairman and CEO, FINRA, Remarks at FINRA Fall Securities Conference, Scottsdale, AZ, Oct. 11, 2007, *available at* http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P037180.

underlying a related financial instrument, prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete. Similarly, members and associated persons would be precluded from buying or selling an underlying *security* when they have material, non-public market information concerning an imminent block transaction in a related financial instrument or a security underlying a related financial instrument, prior to the time that the block transaction has been made publicly available or has otherwise become stale or obsolete.[14]

FINRA's use of the term "security" in the proposal is overly broad and may be read to include fixed income instruments within the scope of the rule. Historically, FINRA's Front Running Policy extended only to equities and equity-based instruments, including options and security futures.[15] We are not aware of any significant regulatory concerns relating to front running of fixed income block orders. These instruments trade and operate in markets different from equity securities. Specifically, fixed income pricing is impacted to a much greater extent by interest rates, credit spreads, a bond's liquidity, and the specific creditworthiness of the issuer.[16] It is unclear whether or the extent to which prior knowledge of an imminent "block" transaction in a fixed income security would permit a firm to predict the effect on the price of the security such that front running regulation is necessary. It also is worth noting that the concept of a block transaction does not translate neatly to the fixed income markets where typical quotation and trading sizes vary by specific fixed income product.[17] While we understand the goal of capturing equity-related instruments under the proposal (including, for example, convertible debt securities), this aspect of the proposed rule also should be limited to instruments related to equity securities. Given the absence of demonstrated front running problems and the differences between the fixed income and equity markets, we do not believe FINRA should extend the Front Running Policy to the fixed income market without a more detailed analysis regarding the need for such a rule and its potential impact on that market.

In this regard, FINRA should modify the proposed rule language and Supplementary Material to focus on equities and equity-related financial instruments by changing "security"

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[14] The proposal also would apply to the accounts of customers provided with material non-public market information concerning an imminent block transaction.

[15] *See, e.g.*, NASD Regulatory and Compliance Alert Vol. 10, No. 3 (Fall 1996) (in the context of NASD's decision to hold off applying its front-running policy to government securities, describing its front running interpretation as designed to apply to equity securities); NASD NTM 96-66 (Oct. 1996) (temporarily excepting the application of IM-2110-3 to government securities because IM-2110-3 "applies, by its terms, only to equity securities").

[16] *See, e.g.*, Roger D. Blanc, Wilkie Farr & Gallagher, Exemption From, and Temporary No-Action Position Under, the Order Execution Rules for Trading in Preferred Securities (Jul. 31, 1997); Exchange Act Rel. No. 38067 (Dec. 20, 1996) (adopting an exception to Rule 101 of Regulation M for certain nonconvertible debt securities); Exchange Act Rel. No. 57621 (Apr. 4, 2008) (distinguishing fixed income instruments and non-convertible preferred stock from equity and excluding the former from Rule 611(a)).

[17] For instance, a round lot in high grade fixed income securities generally may range from $2 million - $5 million, whereas a round lot in high yield fixed income securities generally is viewed as between $1 million - $2 million.

references to "equity security" and changing "related financial instrument" to "financial instrument related to an equity security."[18]

B. Determining the Scope of Related Financial Instruments

In addition to appropriately limiting the proposed rule to those financial instruments that are related to equity securities, FINRA should publish guidance regarding certain instruments that may present particular challenges in determining whether they are related to an underlying security. Although language in the proposing release indicating that a related financial instrument, in essence, means a security that is materially related to a security, acts as a substitute for a security, or is the functional equivalent of a position in a security will be helpful in most instances, basket and index transactions may, for example, present just such challenges. In this regard, we note that other SROs have provided more objective standards for assessing when an index or basket is related to an underlying security. For example, CBOE, as well as other SROs, apply a ten percent test to orders involving component securities when analyzing whether such trades are related to an order to buy or sell an index or basket.[19] FINRA should adopt a more objective standard, such as a percentage or number of names in a basket or program, as a rebuttable presumption that an instrument is related to the underlying security while allowing firms to demonstrate by a reasonable methodology whether an instrument is or is not related to the underlying security.[20]

Some instruments, although marginally linked to equity securities, are sufficiently complex that it will be virtually impossible to determine whether they will constitute a related security, and if so, whether trades involving them meet the threshold for application of the rule. For example, variance swaps and volatility swaps fall into this category.[21] Given the difficulty in assessing whether they are related financial instruments and the possibility that such trades could occur while a firm also is separately trading in an associated equity security, we recommend that FINRA exclude these instruments from the scope of the rule.

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[18] As noted above, the proposed Front Running Policy should be limited to transactions involving publicly reported block trades.

[19] *See, e.g.*, CBOE Rule 6.9(e) ("... a "related instrument," means, in reference to an index option, an order to buy or sell securities comprising ten percent or more of the component securities in the index or an order to buy or sell a futures contract on any economically equivalent index"); *see also*, PHLX Rule 1064(d), NYSE Arca Rule 6.49, and AMEX Rule 950.

[20] We note that the difficulty faced by firms in tracking for overlap between single asset and basket or index transactions has been previously considered and ultimately addressed through use of information barriers. *See*, NYSE Information Memo 01-21 (Aug. 9, 2001) (discussing the use of information barriers with respect to program trading). This historical treatment highlights the challenges of establishing and implementing standards for effective surveillance. We would ask FINRA to consider exempting these types of transactions to the extent they are managed as part of principal-based, capital commitment trading operations.

[21] For example, a variance swap allows one to speculate or hedge based on the volatility of an underlying product.

C. FINRA Should Create a New Standard to More Effectively Capture Trades that Have the Potential to Move the Market

As part of its comprehensive reexamination of its trading rules, the use of "block transaction" as the threshold for identifying transactions subject to the Front Running Policy should be revisited by FINRA. As currently defined in NASD IM 2110-3, a "block transaction" includes a transaction involving 10,000 shares or more of an underlying security, or options or security futures covering such number of shares (although a transaction of less than 10,000 shares could be considered a block transaction in appropriate cases).[22] The Supplementary Material to the proposed rule would expand this definition by substituting "related financial instruments" for options and securities futures.[23]

Notwithstanding its prior utility, we believe that the definition of a block transaction no longer effectively captures the types of transactions that the Front Running Policy is designed to address. For example, it is not at all clear that a 10,000 share order will have much impact on the market for a particularly active equity security. By contrast, a much smaller trade could have substantial impact on the market for a less active stock. Given the expansive nature of the proposed rule, we believe FINRA should focus the rule on "material transactions" rather than block trades. A material transaction might be defined in any number of ways. For example, FINRA could establish threshold sizes for material transactions that vary based on whether the publicly reported transaction involves a large cap, mid cap or small cap security. Alternatively, threshold sizes for different securities might be tied to indices with which they may be associated (*e.g.*, S&P 500, Russell 2000). FINRA might also consider simply increasing the threshold for a material transaction (*e.g.*, 100,000 shares) while permitting firms flexibility to rebut this presumption by showing that an ostensibly material transaction in fact had no impact on the market (such as by focusing on the average daily trading volume or absence of price movement for a security). SIFMA would be pleased to work with FINRA to establish an appropriate threshold for application of the Front Running Policy.

D. FINRA's Proposal Should Confirm the Scope of the Term Customer

The proposed rule contains several exceptions related to facilitating a customer order. The term "customer" is not defined in the proposed rule, but is defined in NASD Rule 0120(g) as a non broker or dealer. With respect to OTC derivatives, dealers are often organized as banks, bank branches of foreign banks, or unregistered affiliates of broker-dealers. In light of their sophistication and market making role, FINRA should clarify that, for purposes of the proposed rule, such unregistered counterparties do not qualify as a "customer."

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[22] NASD Rule IM-2110-3. We also note that "blocks" are defined somewhat differently in other rules. *See, e.g.*, NYSE Rule 127 (defining a block as at least 10,000 shares or a quantity of stock having a market value of $200,000 or more, whichever is less, which is acquired by a member organization on its own behalf and/or for others from one or more buyers in a single transaction).

[23] FINRA Regulatory Notice 08-83, Supplementary Material .03 (Dec. 2008).

II. Application of the Proposal to Non-Reportable Instruments -- The Stale and Obsolete Standard is Too Subjective

FINRA's current Front Running Policy is limited to securities transactions reported via last sale reporting systems.[24] Proposed Rule 5270 also would apply to related financial instruments that may not result in publicly reported trades. The proposed rule provides that trading prohibitions related to such instruments are to remain in place until the relevant material non-public information becomes "stale or obsolete."

For the reasons discussed at the outset of this letter, we strongly believe FINRA should limit the Front Running Policy to transactions involving block trades of publicly reported instruments. Such an approach would eliminate much of the difficulty associated with the proposed Front Running Policy while preserving the traditional prophylactic focus of the rule. Absent this, SIFMA is concerned that the subjectivity that inevitably will be involved in determining when information regarding an instrument that is not subject to public trade reporting becomes "stale or obsolete" will result in many unwarranted regulatory inquiries, examination findings and, perhaps, enforcement actions. Although NTM 05-51 uses a similar standard in describing a firm's duty to refrain from trading prior to the receipt of an order when a firm is involved in the negotiation of certain orders,[25] in practice, much of this guidance has been applied in the context of VWAP and other orders involving equity securities where the transaction will be publicly reported. Firms have adopted policies and procedures to govern instances where, for example, they may have provided a blind bid to a customer upon request but did not receive the business. However, the latter situations occur fairly infrequently relative to VWAP facilitation activities. We are concerned that the proposal to include a broader universe of related instruments that are not publicly trade reported in the Front Running Policy will only increase the number of judgments necessary to determine when information becomes stale or obsolete.

SIFMA would be pleased to work with FINRA to develop more guidance on when material non-public information that is not ultimately publicly reported becomes stale or obsolete. However, without further guidance it will be particularly important for FINRA examiners to recognize the subjectivity and lack of a uniform standard in this area and to focus their examinations on a firm's policies and procedures in this area. FINRA historically has pursued front running related enforcement actions against firms where there has been a clear misuse of information in an attempt to move the market and benefit from such information.[26] In light of the subjectivity in the proposed rule, it will become even more important for FINRA to apply its resources to pursuing clear violations of the Front Running Policy.

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[24] NASD IM-2110-3; *see also*, Notice to Members 87-69 (Oct. 1987).

[25] NASD Notice to Members 05-51 (Aug. 2005).

[26] *See, e.g., Department of Enforcement vs. Jericho Nicolas, Angel Cruz and Anthony Joseph Martinez*, CAF040052 (Mar. 12, 2008).

III. Knowledge Standard in Supplementary Material .01

A. Confirm that the Knowledge Standard is the Same as that in NTM 05-51

Notwithstanding differences in language, it is our understanding that the knowledge standard in Supplementary Material .01 is intended to be applied in the same manner as that in NTM 05-51. Supplementary Material .01 states that a duty to refrain from trading may attach upon knowledge of less than all terms of the transaction so long as there is knowledge that all the material terms of the transactions have been or will be agreed upon imminently. NTM 05-51 interprets the duty to refrain from trading as applying when a firm receives specifics of a transaction "to a degree of confidence whereby the [firm] can engage without undue speculative risk in targeted hedging or positioning activity..." We respectfully request that FINRA clarify the appropriate interpretation and scope of the knowledge standard in its proposal.

B. Knowledge Standard: Block Orders for Both an Option and an Underlying Security

FINRA's current Front Running Policy provides an exception from the knowledge standard (and, consequently, from the prohibitions of the rule) for situations when a member receives a customer order of block size relating to both an option and an underlying security or both a security future and an underlying security.[27] In its proposal, FINRA deleted these exceptions. We understand that these trades have never presented regulatory concerns and request that FINRA confirm that such transactions will continue to be permissible under the proposed rule.[28]

IV. Permissible Transactions

A. Generally

Like the current Front Running Policy, Supplementary Material .04 to the proposed rule excludes certain transactions from the front running prohibition, including: (i) transactions related to a prior customer order; (ii) "black box" orders where the member has no actual knowledge that the customer order has been routed for execution; (iii) trades to correct bona fide errors; and (iv) off-lot transactions to offset odd-lot orders. Additionally, an exception exists for bona fide hedging that requires a firm to demonstrate that the trading was unrelated to material non-public information related to the customer order and was subject to an information barrier.

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[27] NASD IM-2110-3(b).

[28] It may be the case that Supplementary Material .04, which permits trading activity where the member can demonstrate it is unrelated to the material non-public information received in connection with the customer order includes trading in connection with orders involving an option and the underlying security. Nonetheless, we believe it is useful to clarify the permissibility of these transactions under the proposed rule. As noted previously and below in Section IV.B, FINRA should conform the references to "material non-public information" in Supplementary Material .04 to "material non-public market information," as used in the current rule and in the rest of the proposed rule.

As noted above, FINRA should first clarify that the proposed rule change is not meant to modify the manner in which firms conduct their OTC equity derivatives business – namely, through the disclosures and agreements set forth in ISDA agreements with sophisticated counter-parties. We also believe the list of permissible activities in the proposed rule may be simplified. Specifically, any one or more of the following transactions should be permitted under the proposed Front Running Policy:

1. Transactions unrelated to material, non-public market information related to the customer order;

2. Transactions that were subject to an information barrier;

3. Transactions where a customer receives written notice about a firm's hedging activity;[29]

4. Transactions related to a prior customer order;

5. Transactions involving "black box" orders;

6. Riskless principal transactions;

7. Facilitation transactions;

8. Bona fide error corrections; or

9. Odd-lot transactions.

We note that, as currently drafted, the first two exceptions of the proposal would permit trading unrelated to material non-public market information only where there also is an information barrier and vice versa. Thus, the proposal will mandate the use of information barriers in situations where they are unnecessary. We believe that the existence of an information barrier obviates the need to also show that information is also unrelated to material non-public market information. FINRA should clarify the proposed rule to permit either transaction.

B. Material Non-Public Market Information

Like current IM 2110-3, proposed Rule 5270 prohibits front running when a firm has "material non-public market information" concerning an imminent block transaction. However, proposed Supplementary Material .04 provides an exception from the prohibition of the rule where a firm can demonstrate that its trading is unrelated to the "material non-public information" received in connection with a customer order, or where a firm can show, among other things, that a hedge is unrelated to "material non-public information" in connection with a customer order. Because both terms, in this context, are meant to apply to information related to

[29] The requirement to provide written notice should not apply where the terms of a customer order implicitly convey the customer's consent to a firm's hedging activity (*e.g.*, a customer "stop order").

the relevant block transaction, and since "material non-public information" is used in a variety of other, unrelated contexts throughout the federal securities laws, FINRA should conform references in the Supplementary Material to language describing "material non-public market information" in the current and proposed rule to avoid any potential for confusion.

C. FINRA's Proposal Should Define Black Box Orders

As discussed above, an exception from the trading prohibitions of the Front Running Policy exists for black box orders. This term is undefined in the proposed rule and we suggest that the term "black box orders" include orders entered either by the customer, firm or its associated person into a computerized facility that will at periodic intervals during the trading day send a portion of the overall order, without intervention by the firm or its associated persons, for execution.[30] If the firm does not have actual knowledge that, in fact, a portion of the order has been sent for execution, the firm may enter proprietary orders in the same security without being deemed in violation of FINRA's proposal.

V. Consent Standard: FINRA Proposal Should Permit Written Disclosure in Connection with Hedging Activities Consistent with NYSE Information Memo 05-52

Proposed Supplementary Material .04 would require a customer's affirmative written consent to engage in positioning or hedging activity. FINRA and the NYSE have issued different guidance regarding a firm's disclosure obligations to its customers when it engages in anticipatory hedging and other positioning activity.[31] Specifically, FINRA requires that a member firm disclose in writing to a customer, prior to receipt and/or execution of a VWAP or other large order, that it intends to engage in hedging or other positioning activity related to the handling of the order.[32] This disclosure must be in the form of affirmative written consent and firms are required to have customers reaffirm their consent at least annually. Alternatively, NYSE Information Memo 05-52 requires similar disclosure but permits firms to deliver written disclosure to a customer prior to receipt and/or execution of the order without requiring affirmative written consent.

More than three years have passed since FINRA and NYSE issued this interpretive guidance and established these disclosure regimes. We are unaware of information that suggests the affirmative written notice required by the NYSE has resulted in any less customer protection than FINRA's approach. Moreover, NYSE's approach is easier for firms to control and implement and provides direct disclosure to customers without the administrative burden of ensuring that customers return a response. Therefore, we recommend that FINRA adopt a written notice standard for consent to trading activities performed by the firm and allow firms to reasonably tailor such disclosures to their business and practices.

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[30] Firms should be permitted, consistent with this definition, to cancel or modify the terms of an order at a customer's request.

[31] *See* NASD Notice to Members 05-51 (Aug. 2005); NYSE Information Memo 05-52 (Aug. 2005).

[32] *Id.*

We do believe, however, that there may be value to FINRA providing additional guidance on the type of disclosure contemplated by the rule through the publication of sample disclosure. We stand ready to work with FINRA to craft sample guidance or an industry-wide standard disclosure that would help avoid customer confusion in this area.

Finally, the ongoing trading obligations of members that obtain customer consent to hedging and other positioning activity is somewhat unclear under Supplementary Material .04. Specifically, the Supplementary Material notes that firms obtaining customer consent "must still refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interest ahead of those of its customer."[33] By contrast, in discussing the obligations of firms engaged in such activities, NASD NTM 05-51 indicates that members receiving customer orders are obligated to (1) refrain from conduct that could disadvantage or harm the execution of a customer's order, and (2) if applicable, disclose in writing to the client that the firm's hedging activities could affect the market for the security. Any hedging associated with a large order has the potential to impact the market for the underlying security and, thereby, "disadvantage" or "harm" the execution of a customer's order. Given that firms engaged in this practice are required to disclose this possibility to their customers, we suggest that FINRA clarify that the admonition against any further harm to the customer in such circumstances is meant to apply to conduct or actions that a firm should have reasonably known would cause extreme market impact or is substantially unrelated to the risks it incurred by entering into the transaction and which, thereby, severely disadvantages or harms the execution of the customer's order.

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We appreciate the opportunity to provide comment on FINRA's proposed modifications to the Front Running Policy. SIFMA would be pleased to discuss any comments herein, or provide FINRA with any additional assistance as it proceeds with the rule proposal. Please do not hesitate to contact us at 202-962-7300 or 212-313-1000 if you have any questions.

Sincerely,

Ann Vlcek
Managing Director and Associate General Counsel

/s/ Gerard J. Quinn
Gerard J. Quinn
Managing Director and Associate General Counsel

[33] Regulatory Notice 08-83, Supplementary Material .04.

EXHIBIT 5

Exhibit 5 shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

Text of Proposed New FINRA Rule
(Marked to Show Changes from NASD IM-2110-3;
NASD IM-2110-3 to be Deleted in its Entirety from the Transitional Rulebook)

* * * * *

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

(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 customer accounts, to cause to be executed:]

[(a)] 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, a related financial instrument or a security underlying the related financial instrument prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete. [or when a customer has been provided such material, non-public market information by the member or any person associated with a member; or]

[(b) 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 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.]

(b) This Rule applies to orders caused to be executed for any account in which such member or person associated with the member has an interest, any account with respect to which such member or person associated with a member exercises investment discretion, or for accounts of customers or affiliates of the member when the customer or affiliate has been provided such material, non-public market information by the member or any person associated with the member.

(c) For purposes of this Rule, the term "related financial instrument" shall mean any option, derivative, security-based swap, 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] fewer 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.

(a) Rule 5270 does not preclude transactions that the member can demonstrate are unrelated to the material, non-public market information received in connection with the customer order. These types of transactions may include:

(1) transactions where the member has information barriers established to prevent internal disclosure of such information;

(2) transactions in the same security related to a prior customer order in that security;

(3) transactions to correct bona fide errors; or

(4) transactions to offset odd-lot orders.

(b) Rule 5270 does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, the customer block order. However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the member must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the member's financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity. A member may obtain its customers' consent through affirmative written consent or through the use of a negative consent letter. The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders; if the customer does not object, then the member may reasonably conclude that the customer has consented and the member may rely on such letter for all or a portion of the customer's orders. In addition, a member may provide clear and comprehensive oral disclosure to and obtain consent from the customer on an order-by-order basis, provided that the member documents who provided such consent and such consent evidences the customer's understanding of the terms and conditions for handling the customer's order.

(c) The prohibitions in Rule 5270 shall not apply if the member's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.

.05 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 and Rule 5320, or provisions of the federal securities laws.