Financial Industry Regulatory Authority

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August 29, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: SR-FINRA-2012-025 — Proposed Rule Change to Adopt FINRA Rule 5270 in the Consolidated FINRA Rulebook — Response to Comments

Dear Ms. Murphy:

The Financial Industry Regulatory Authority, Inc. ("FINRA") hereby responds to the comment letters received by the Securities and Exchange Commission ("Commission" or "SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-FINRA-2012-025.[1] The Proposal adopts NASD Interpretive Material ("IM") 2110-3 (Front Running Policy) as FINRA Rule 5270 with several notable changes, including extending the rule to cover a wider range of securities and adopting Supplementary Material outlining permitted transactions. The Commission received two comment letters on the Proposal: one from the Securities Industry and Financial Markets Association ("SIFMA") and one from the Public Investors Arbitration Bar Association ("PIABA").[2]

PIABA generally supports the Proposal and suggests that FINRA closely monitor firms' use of the permitted transactions "to ensure that member firms are not using 'permitted transactions' as a loop-hole to engage in activity that the proposed rule intends to end." As with all of its rules, FINRA intends to examine firms for compliance with, and fully enforce, Rule 5270.

SIFMA's letter raises three specific points, which FINRA describes and responds to below.[3]

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1 *See* Securities Exchange Act Release No. 67079 (May 30, 2012), 77 FR 33522 (June 6, 2012) (Notice of Filing of File No. SR-FINRA-2012-025) ("Proposal").

2 Letter to Elizabeth M. Murphy, Secretary, SEC, from Sean Davey, Managing Director, Corporate Credit Markets Division, SIFMA, dated July 9, 2012; letter to Elizabeth M. Murphy, Secretary, SEC, from Ryan K. Bakhtiari, President, PIABA, dated June 26, 2012.

3 SIFMA also notes that it still had concerns similar to those raised in its comment letter on *Regulatory Notice* 08-83 to the extent FINRA did not change the

First, SIFMA requests clarification on what "serves as the trigger for lifting trading restrictions" under Rule 5270 and asserts that the trading restrictions should be lifted once the risk of a transaction has been transferred from the customer through execution of the order (e.g., if the firm executes the customer's order as principal and then trades the same security for its own account). SIFMA suggests this would be the case even in those circumstances where prompt trade reporting is required and trade data is publicly disseminated. In essence, SIFMA suggests that, for purposes of the front running rule, information regarding an order can become "stale or obsolete" even if the order was in a security subject to prompt last sale reporting requirements. SIFMA notes that a transfer of risk standard would not obviate other rules, such as those concerning just and equitable principles of trade[4] and trade reporting.[5] SIFMA bases its conclusion on its assertion that "[t]he purpose underlying the proposed rule is, as noted in the [Proposal], that 'firms should not use their knowledge of imminent block transactions to benefit themselves at the expense of their customers.'"

As an initial matter, Rule 5270, like NASD IM-2110-3, serves purposes beyond protection of the customer's block order; it also serves to prevent members from using material, non-public market information in the form of a customer's block order for their own benefit, even if the customer's order is not affected.[6] Although FINRA did state in the Proposal that "the primary issue [Rule 5270] is designed to address is [that] firms should not use their knowledge of imminent block transactions to benefit themselves at the expense of their customers," it is not the *only* issue addressed by the rule. As noted in the Proposal, FINRA's intention behind expanding the rule to additional securities is "to make clear that misusing material, non-public market information . . . is impermissible, regardless of the type of security" involved. This misuse can, and often will, have a

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proposed rule in response to SIFMA's earlier comments. FINRA responded to SIFMA's initial comments in the Proposal.

4 *See* FINRA Rule 2010 (requiring members to "observe high standards of commercial honor and just and equitable principles of trade").

5 Trades in equity securities generally must be reported within 30 seconds of execution. *See, e.g.*, FINRA Rules 6380A(a); 6380B(a); 6622(a). FINRA has emphasized that firms must report trades as soon as practicable and cannot withhold trade reports (e.g., by programming their systems to delay reporting until the last permissible second). *See, e.g.*, *Regulatory Notice* 10-24 (April 2010).

6 *See* Securities Exchange Act Release No. 25233 (December 30, 1987), 53 FR 296 (January 6, 1988) (noting that 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").

detrimental impact on the customer's order, but it need not; it is sufficient that the misuse have a detrimental impact on members of the public.[7]

With these primary regulatory goals in mind, the trading prohibitions in Rule 5270 remain in place until "the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete." Supplementary Material .02 states that "[t]he requirement that information concerning a block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported." As FINRA noted in the Proposal, the addition of the "stale or obsolete" standard was proposed because some of the related financial instruments now covered in Rule 5270 are not subject to reporting requirements, and transaction information regarding these instruments is not disseminated publicly. The "stale or obsolete" standard was intended to supplement, not replace, the existing dissemination standard.[8] Consequently, where there is a transparency regime in place with respect to the security or financial instrument (i.e., transactions are subject to prompt reporting requirements and the transaction reports are disseminated) the trading restrictions in Rule 5270 are linked to actual reporting and dissemination rather than by invoking the "stale or obsolete" standard.[9] Where there is no reporting and dissemination regime in place for the security or financial instrument, the ability of the firm to use the material, non-public market information regarding its customer's block order to the detriment of its customer or the market in general is significantly reduced. In those circumstances, FINRA agrees with SIFMA that, once the customer's order is executed and the risk of the transaction has transferred from the customer to the firm, there would be no trading restrictions imposed by Rule 5270.

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7 *See id.* ("The SROs' circulars [containing their front running policies] state that the use by an Exchange member of such material, non-public information to trade for his own benefit and to the detriment of members of the public as well as other Exchange members is activity inconsistent with just and equitable principles of trade and a violation of Exchange rules.").

8 Under NASD IM-2110-3, information regarding a block transaction is considered publicly available "when it 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."

9 This would include debt securities subject to TRACE reporting requirements, even though the TRACE reporting requirements generally allow for up to 15 minutes to report transactions in corporate and agency debt securities. *See* FINRA Rule 6730(a). As noted above, in *supra* note 5, there should generally be minimal, or no, delay between the execution of the order and the reporting of the trade.

Second, SIFMA asks FINRA to clarify the relationship between the existing guidance provided in NASD *Notice to Members* 05-51 (the "*Notice*"), FINRA Rule 5320,[10] and Rule 5270. SIFMA specifically asks that FINRA make clear that (1) the negative consent letter permitted under new Supplementary Material .04 to Rule 5270 satisfies, and is consistent with, the *Notice*, and (2) the duties set out in the *Notice* arise "on the basis of the same analysis as the obligations under proposed Rule 5270."[11] The *Notice* addresses members' obligations involving large, potentially market-moving orders received from a customer, such as VWAPs, institutional orders, and basket transactions. The *Notice* states that, when a member receives such an order, it must "(1) 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's and (2) if applicable, disclose in writing to the customer that the member intends to engage in hedging and other positioning activity that could affect the market for the security that is the subject of the transaction."[12] The *Notice* states that the disclosure must be in the form of an affirmative consent letter, but the disclosure need not be on a transaction-by-transaction basis.

As a general matter, FINRA agrees that, to the extent possible, the new Supplementary Material should be read consistently with the *Notice* and the obligations set out in Rule 5320. As FINRA noted in the Proposal, the Supplementary Material was intended to acknowledge FINRA's previous guidance, and the disclosure and consent provision in Supplementary Material .04 mirrors that in Rule 5320. The duties set out in the *Notice* do arise from the same concerns Rule 5270 is designed to address. As stated in the *Notice*, members must "handle and execute any order received from a customer in a manner that does not disadvantage the customer or place the member's financial interests ahead of those of its customer." Moreover, the *Notice* states that "[o]ther than for the purpose of fulfilling the customer order, under no circumstances may a member trade for its proprietary account on the non-public information it receives from the current or prospective customer or communicate such non-public information to another entity or person outside the member [unless] the member has established effective information barriers reasonably designed to prevent internal disclosure of the non-public information."

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10 Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) generally prohibits a member that accepts and holds a customer order in an equity security without immediately executing the order from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

11 *See* SIFMA.

12 The *Notice* refers to these obligations collectively as "the duty to refrain and disclose."

FINRA believes that Rule 5270 and its Supplementary Material encapsulate the obligations established in the *Notice* with the difference noted by SIFMA: the disclosure obligation in Supplementary Material .04 can be in the form of negative consent or, provided certain criteria are met, oral consent, which is not permitted by the duty to refrain and disclose as set out in the *Notice*. Provided a member has met the disclosure obligation set forth in Supplementary Material .04, which permits negative and certain oral consent, the member may engage in the trading activity identified in that provision; namely, transactions undertaken for the purpose of fulfilling, or facilitating the execution of, the customer block order. FINRA stresses that, in addition to complying with the disclosure obligation in Supplementary Material .04, the member must minimize any potential disadvantage to the customer or harm in the execution of the customer's order, and the member must not place its financial interests ahead of those of its customer. Provided a firm meets all of the criteria in Supplementary Material .04, it has fulfilled its duty to refrain and disclose as set out in the *Notice*.

Finally, SIFMA requests that FINRA extend the proposed implementation date of the proposed rule. FINRA stated in the Proposal that the proposed rule change would have an implementation date within 90 days of publication of a *Regulatory Notice* announcing the SEC's approval of the Proposal. SIFMA requests a period of 180 days following publication of the *Regulatory Notice* because of technological changes some firms may need to make to incorporate the expansion of the rule to fixed income and derivative instruments. FINRA has no objection to providing firms with the additional time requested by SIFMA and proposes to change the implementation date for the proposed rule change to within 180 days following publication of the *Regulatory Notice* announcing the SEC's approval of the rule.[13]

FINRA believes that the foregoing fully responds to the issues raised by the commenters. Please feel free to contact me at (202) 728-6927 if you have any questions.

Sincerely,

Brant K. Brown

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13 FINRA notes that, although it agrees to provide for a longer implementation date for the proposed rule, much of the trading activity prohibited by Rule 5270 may violate other existing FINRA rules.