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

Re: File No. SR-FINRA-2009-090 — Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing, a proposed rule change to adopt NASD Interpretive Material (IM) 2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) with significant changes in the Consolidated FINRA Rulebook as new FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders).¹ The SEC published the proposed rule change for notice and comment on December 22, 2009 and received four comment letters.²

All of the commenters generally support FINRA’s effort to integrate the limit order protection rule and the market order protection rule into a single rule; update and

¹ See Securities Exchange Act Release No. 61168 (December 15, 2009), 74 FR 68084 (December 22, 2009) (“Proposing Release”).

² Letter from Patrick Chi, Chief Compliance Officer, ITG Inc., to Elizabeth M. Murphy, Secretary, SEC, dated January 12, 2010 (“ITG”); Letter from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets Inc., to Elizabeth M. Murphy, Secretary, SEC, dated January 18, 2010 (“Pink”); Letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated January 28, 2010 (“SIFMA”); and Letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., and Michael T. Corrao, Chief Compliance Officer, Knight Equity Markets, L.P., to Elizabeth M. Murphy, Secretary, SEC, dated February 22, 2010 (“Knight”) (available at <http://www.sec.gov/comments/sr-finra-2009-090/finra2009090.shtml>).

simplify the rules' provisions in light of changes in market practices; and work toward a uniform industry standard with respect to the customer order protection rule. However, commenters raise concerns regarding the scope of the proposed rule change and argue for certain additional modifications, as discussed below.

Scope of the Rule

At present, IM-2110-2 and Rule 2111 apply to customer limit orders and market orders, respectively. The proposed rule change would provide that, subject to certain exceptions, a member that accepts and holds an order in an equity security from its own customer (or the customer of another broker-dealer) without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

Some commenters believe that proposed Rule 5320 should apply only to limit orders and market orders.³ For example, SIFMA states that it is not appropriate to apply the proposed rule to "not held" orders because a "not held" order is neither a market nor a limit order and, by definition, provides a broker-dealer with flexibility through a grant of price and time discretion to exercise its professional judgment in handling the order.

As noted by commenters, FINRA in the past has provided clarification regarding the application of the order protection rules to "not held" orders.⁴ Generally, a "not held" order is an un-priced, discretionary order voluntarily categorized as such by the customer. A broker-dealer with such an order must use its brokerage judgment in the execution of the order, and if such judgment is properly exercised, the broker is relieved of its normal responsibilities with respect to the time of execution and the price or prices of execution of such an order.

Because the customer has given the member price and time discretion, the proposed rule would not be applicable to the order given there is not a specific price parameter limitation to apply to the member's proprietary trading. However, as stated in Notice to Members 97-57, a member must clearly document that it has obtained the authorization of the customer to work the order and also must disclose to the customer that such discretion means that the member may trade at the same price or at a better price than that received by the discretionary order. In addition, because the customer has granted the member the discretion to work the order, the member, as agent, has a clear responsibility to work to obtain the best fill considering all of the terms agreed to with the

³ See ITG and SIFMA.

⁴ See Notice to Members 97-57 (September 1997) and Notice to Members 95-43 (June 1995).

customer and the market conditions surrounding the order. In the absence of a clear understanding between the member and the customer regarding the member's activities in competing with the customer order, the member could potentially violate its duty of best execution and to adhere to just and equitable principles of trade in the way it "works" the order.

SIFMA stated in its letter that the current rules apply only to orders in exchange-listed and OTC Equity Securities and requested guidance that the proposed rules would continue to apply only to those categories of securities.⁵ FINRA is clarifying that Proposed Rule 5320 would apply to securities that meet the definition of "OTC Equity Security" as defined in FINRA Rule 6420⁶ as well as securities that meet the definition of "NMS stock" as defined in Rule 600 of SEC Regulation NMS.

No-Knowledge Exception

The proposed rule change seeks to extend the scope of the existing no-knowledge exception to include market-making desks with respect to orders in "NMS stock," as defined in Rule 600 of SEC Regulation NMS. Thus, members would be able to "wall off" their market-making desks, as well as other proprietary desks, from customer order flow in NMS stocks without knowledge of customer orders being imputed to such walled-off desks where actual knowledge does not exist. Several commenters argued that, while they support the expansion of the no-knowledge exception to market making desks for NMS stocks, they do not believe that there is good reason not to also extend the exception to OTC Equity Securities at this time.⁷ For example, SIFMA states that the over-the-counter ("OTC") market is evolving in the same manner as exchange-listed securities and has evolved to become sufficiently liquid and electronic to warrant the application of the no-knowledge exception to market-making desks. SIFMA further states that, as with exchange-listed securities, many firms may prefer to handle retail-sized customer orders in OTC Equity Securities on an automated basis, separate and apart from their proprietary trading desks, including market making desks.

While we acknowledge that there have been developments in the trading of OTC Equity Securities since the adoption of the original interpretation, we continue to believe that the degree of automation in the market for OTC Equity Securities has not evolved to a level equal to the trading of NMS stocks. As stated in the original rule filing, OTC

⁵ See SIFMA.

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

⁷ See Knight, Pink and SIFMA.

Equity Securities are generally not traded at market centers with the same depth of liquidity and, therefore, we believe there is a continued benefit to customer orders interacting with the market making desk as a critical source of liquidity for customer orders. In addition, trades in OTC Equity Securities are not as susceptible to automated routing for best execution; therefore, we do not agree that it is appropriate to permit members to wall off customer orders in OTC Equity Securities from the market-making desk for purposes of the proposed rule.

Commenters also argue that members should not be required to use a separate Market Participant Identifier (“MPID”) for each walled-off desk.⁸ Specifically, commenters argue that the rule should not require firms to obtain a unique MPID, but rather should permit it as optional and require members to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trading ahead. Certain commenters argue that separate MPIDs could pose considerable administrative burdens for firms.⁹ For example, commenters assert that introducing additional new MPIDs would make FINRA’s Order Audit Trail System, Trade Reporting Facility and other regulatory reporting requirements more complex and expensive, and would exacerbate the potential for operational and technical problems with such reporting.¹⁰ SIFMA states that firms also may need to make related changes to their clearing systems and may be required to obtain certifications with existing clients for which they clear and for all destinations to which firms route.

FINRA recognizes that this proposed requirement may impose additional costs and burdens on members; however, FINRA continues to believe it is important that members use a separate MPID in concert with effective internal controls and disclosure to customers regarding the member’s order handling practices. A separate MPID would serve as an important tool in the surveillance process and makes it possible for FINRA to determine from automated trade reporting data which trades were executed from each walled-off desk.

Extended Trading Hours

One commenter opposes the expansion of the rule to extended hours trading.¹¹ This commenter asserts that customers who send orders for extended hours trading tend to be more sophisticated and, hence, such orders should be handled like institutional

⁸ See Knight and SIFMA.

⁹ See Knight and SIFMA.

¹⁰ See SIFMA.

¹¹ Id.

orders even if they are smaller in size or submitted by an individual investor.¹² FINRA continues to believe that the scope of the proposed rule is appropriate. Notwithstanding that, as cited by commenters, the protections afforded by other rules for NMS securities are limited to regular trading hours and that special risk disclosures are required for members who permit customers to trade in extended hours sessions, we believe customer order protection should apply at all times that a customer order can be executed. If a member executes a trade for its own account in an extended hours session at a price that would satisfy an executable customer order, the rule should apply.

One commenter further believes that the application of the rule to extended hours trading is particularly onerous for firms that execute transactions in foreign securities because the currency conversion rate may fluctuate between the time of order entry and execution, resulting in an execution price that triggers the rule.¹³ The commenter did not indicate how frequently the fluctuations of currency conversion rates would, in fact, have such an impact, but, in any event, FINRA does not believe that the possibility of this occurrence justifies excluding all customer orders in such securities from the protections of the rule. FINRA would look to the member to demonstrate that, at the time of the execution of the proprietary order, the market and currency conversion information available made it reasonable to conclude that, but for any future fluctuations in currency conversion rates, the trade would not occur at a price that would trigger the rule.

Other Issues

One commenter raises concerns regarding the exception that permits market makers to obtain priced quotes from at least two unaffiliated dealers to determine the minimum price improvement obligation for limit orders priced below \$1.00 (where there is no current published inside spread).¹⁴ This commenter believes that a market maker should not be required to omit its own quote from the calculation because this may lead to inferior executions where the market maker in question has the best price on the security. This commenter further asserts that omitting its own quote is not required in the NASDAQ, NYSE, OTCBB and Pink Sheet markets. We do not agree that a market maker should be able to use its own quote in the calculation. If this commenter's argument is that its own published quote would be included in any published best bid or offer calculated on the market on which the quote is displayed (and therefore used in its minimum price improvement calculation), we do not believe that situation is analogous here. This particular exception relies on the market maker being able to obtain independent quotes from unaffiliated broker-dealers, and the reliability of this safeguard

¹² See SIFMA.

¹³ Id.

¹⁴ See Knight.

would be undermined if the market maker were able to include its own quotation in the calculation.

Another commenter argues that FINRA should expand the exceptions to the rule, including providing that members would be relieved from the obligation to execute a customer order if the customer order was received after a member's proprietary quote was published or routed to access a priced quotation.¹⁵ FINRA does not believe these additional exceptions are in the best interest of investors. While we recognize that the rule provides for an exception for member trading where the customer limit order is received after the member routed an intermarket sweep order ("ISO"), we note that this exception is very narrow in scope and of a short duration.¹⁶ Specifically, the exception is only available in connection with ISOs routed in compliance with Rule 600(b)(30)(ii) of Regulation NMS and is based on the assumption that the turnaround time from when an ISO is sent out to execute against the full displayed size of a protected quote and the response time to the sender is extremely short.¹⁷ The intent of the carve-out is to facilitate member firm compliance with Rule 611 of Regulation NMS without compromising important limit and market order protection requirements. However, we do not agree that it is equally appropriate to broadly permit members to trade ahead of customer orders whenever a member first publishes a quote or the proprietary trade has already been routed.

This commenter further asserted that the proposed rule change is inconsistent with the rules adopted by the New York Stock Exchange in connection with its institution of the Designated Market Maker ("DMM") in that the exchange rules give the DMM priority in executions in circumstances where the DMM establishes the quotation prior to other orders.¹⁸ FINRA disagrees that NYSE DMMs should be viewed as analogous to OTC market makers. Specifically, DMMs are not in an agency/customer relationship with other orders on the NYSE book. Because DMMs are not in a customer relationship and trade proprietarily, the customer order protection rules are inapplicable.

¹⁵ See Pink.

¹⁶ See FINRA Rule IM-2110-2(d).

¹⁷ To the extent that a member routes an ISO order with a time-in-force greater than immediate-or-cancel, any portion of the member's order that is not executed immediately would no longer fall within the terms of the exemption, and any subsequent executions must comport with the member's limit and market order protection obligations. See Regulatory Notice 08-31 (June 2008).

¹⁸ See Pink.

Another commenter requests that the protection offered by the rule be limited to orders that use certain defined increments.¹⁹ This commenter argues that the rule would permit customers to take unfair advantage of members by submitting orders that are slightly higher than the member's quote in increments that cannot be displayed by Pink Quote or the OTCBB, but that would trigger price protection and require the member to provide price improvement at a loss. We note that the SEC recently approved a FINRA rule change that generally establishes a minimum increment of \$0.01 for the display of orders in securities priced \$1.00 or greater and \$0.0001 for the display of orders in securities priced under \$1.00 and, therefore, do not think it necessary to separately address price increments in the customer order protection context.²⁰

FINRA believes that the foregoing responds to the material issues raised in the comment letters to this rule filing. If you have any questions, please contact me at (202) 728-8363.

Sincerely,



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¹⁹ Id.

²⁰ See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010). FINRA notes that, while members would not be required to display customer limit orders priced less than \$0.0001 pursuant to the aforementioned new FINRA rule, a member's customer order protection obligations under existing IM-2110-2 (Trading Ahead of Customer Limit Order) and proposed Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) would apply.