

Information Memo 09-13

Information Memo

Nyse Regulation, Inc



NYSE Regulation, Inc. | 20 Broad Street
New York, NY 10005
nyse.com

Number 09-13
March 12, 2009

ATTENTION: ALL MEMBERS AND MEMBER ORGANIZATIONS

TO: ALL MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: REQUEST FOR COMMENTS: PROPOSED HARMONIZATION OF NYSE and NYSE AMEX EQUITIES RULE 92 AND FINRA'S MANNING RULE

I. Purpose

The purpose of this Information Memo is to advise that NYSE Regulation, Inc. ("NYSE Regulation") is soliciting comments on a proposal to adopt a new equities customer order protection rule that in essence would harmonize current New York Stock Exchange ("NYSE") Rule 92 and NYSE Amex Rule 92 – Equities (collectively, "Rule 92") with the Financial Industry Regulatory Authority, Inc.'s ("FINRA") rules prohibiting trading ahead of customer orders. The new harmonized rule would contain elements of both Rule 92 and NASD Rule 2111 and IM-2110-2 (the "Manning Rule"), and is described in brief detail below. Because the harmonized rule would apply to dual NYSE and FINRA members no matter where they trade, NYSE Regulation is soliciting comments in conjunction with FINRA's process of soliciting comments to obtain feed back from interested parties regarding the application of a harmonized rule on both Floor members and upstairs member organizations.

FINRA's proposed Rule 5320 concerning customer order protection, would replace NASD Rule 2111 (Trading Ahead of Customer Market Order) and NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and is described in greater detail in FINRA Regulatory Notice 09-15, dated March 12, 2009. The text of the proposed FINRA Rule 5320 is attached as Attachment A to that Regulatory Notice.

NYSE Regulation believes that a harmonized approach to customer order protection would achieve greater consistency and simplify compliance obligations for members of NYSE, NYSE Amex¹ (Equities) and FINRA. Accordingly, after reviewing comments from interested parties, NYSE and NYSE Amex (the "Exchanges") each propose to file with the Securities and Exchange Commission ("SEC" or the "Commission") a proposed rule to replace each exchange's Rule 92 with a rule similar to proposed FINRA Rule 5320. NYSE Regulation is soliciting comments on the applicability of proposed FINRA Rule 5320 to the Exchanges, and specifically, the items addressed below.

¹ Please note that NYSE Alternext US LLC will shortly be renamed NYSE Amex LLC ("NYSE Amex").

NYSE Regulation encourages all interested parties to submit comments in the manner described below on the proposed FINRA Rule 5320 and its applicability to the Exchanges. Comments must be received by **April 24, 2009**. Comments received after the close of the comment period will not be considered, although interested parties will have further opportunity to comment as it is anticipated that a proposal resulting from this Information Memo process will be filed with the SEC for approval.

Member organizations and other interested parties can submit their comments using the following methods:

- Emailing comments to: rulecomments@nyx.com; or
- Mailing comments to:

Office of the Corporate Secretary
NYSE Euronext
20 Broad Street, 12th Floor
New York, NY 10005

To help NYSE Regulation process and review comments more efficiently, persons should only use one method to comment on the proposal.

Note that all comments received will be made public.

II. Background

A. NYSE Rule 92 and the Manning Rule

NYSE Rule 92 generally prohibits members or member organizations from entering a principal/proprietary ("proprietary") order if the person responsible for entry of that order has knowledge of an unexecuted customer order on the same side of the market that could be executed at that price. Among other provisions, the rule contains several limited exceptions that make it permissible for a member or member organization to enter a proprietary order while representing a customer order that could be executed at the same price. These limited exceptions generally apply only to a customer order from an institutional account or individual with an order of over 10,000 shares and \$100,000 or more in value where that customer has provided affirmative consent or order-by-order consent and such consent has been documented. Rule 92 also includes a riskless principal exception, as well as exceptions for trading by odd-lot dealers, transactions made to correct bona fide errors, and intermarket sweep orders in compliance with Regulation NMS.

NASD Interpretive Material 2110-2 generally prohibits a member firm from trading for its own account in an exchange-listed security or an OTC equity security at a price that is equal to or better than an unexecuted customer limit order in that security, unless the firm immediately, in the event it trades for its own account at a price that is at or better than the customer limit order, executes the customer limit order at the price at which it traded for its own account. Similarly, NASD Rule 2111 generally prohibits a member firm that accepts and holds a customer market order in an exchange-listed security from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order up to the size and at the same price or better at which it traded for its own account. The Manning Rule does not require written affirmative consent or documented order-by-order consent, but rather, allows for the negotiation of terms and conditions for institutional accounts, or orders over 10,000 shares and \$100,000 or more in value.

B. Proposed FINRA Rule on Customer Order Protection

As discussed in greater detail in FINRA's Regulatory Notice 09-15, proposed FINRA Rule 5320 represents a cooperative effort between FINRA and NYSE Regulation to harmonize approaches

to trading ahead of customer orders. To harmonize its Manning Rules, FINRA proposes to create a single rule governing member firms' treatment of customer orders and applying the new rule uniformly to all equity securities. As proposed, the harmonized rule also extends the NASD Rule 2111 protections to OTC equity securities.

With the exceptions noted below, NYSE Regulation also proposes to adopt a rule substantially similar to proposed FINRA Rule 5320 as a new rule to replace Rule 92. Accordingly, the Exchanges would propose to delete Rule 92 and its supplementary material in its entirety and adopt the harmonized approach as the Exchanges' rule on customer order protection.

III. Comments Requested on Impact of proposed FINRA Rule 5320 at the Exchanges

NYSE Regulation is seeking comments from member organizations and interested parties concerning the Exchanges' proposal to adopt a rule similar to proposed FINRA Rule 5320. If a commenter believes that any portion of proposed FINRA Rule 5320 is inapplicable to the Exchanges' equities market structure or needs to be supplemented, NYSE Regulation requests that the commenter identify the section, why it believes it is inapplicable to the Exchanges, and/or any recommendations for adjusting the rule for the Exchanges. Similarly, if a commenter believes that a provision of Rule 92 should be retained, NYSE Regulation requests that the commenter identify why that provision of Rule 92 should be retained instead of the approach proposed in FINRA Rule 5320.

In addition to general comments, NYSE Regulation invites comments on the following issues:

A. Entry vs. execution

NYSE Regulation notes that proposed FINRA Rule 5320 would change the timing of a member or member organization's customer protection obligations. Specifically, under Rule 92, the limitation on a member or member organization's trading is based on knowledge of an unexecuted customer order at the time of entry of the proprietary order. In contrast, under proposed Rule 5320, a customer's order protection is timed from the execution of the proprietary order, which is the same standard previously applied under FINRA's Manning Rule. NYSE Regulation invites comments on whether the Exchanges should adopt the Manning Rule standard for the timing of protection of customer orders. In particular, NYSE Regulation invites comments on whether the entry vs. execution timing of customer order protection would impact a Floor broker or other NYSE member's ability to handle customer orders or effectively represent those orders.

B. Proposed Rule 5320.01 (Large Orders and Institutional Customers)

The Exchanges note that, if adopted as an Exchange rule, proposed FINRA Rule 5320.01 would change the Exchanges' rules governing trading along with an institutional account or orders of 10,000 shares or more, unless such orders are less than \$100,000 in value. Most significantly, it would permit institutional accounts and individual customers with large orders to enter into terms and conditions with a member organization for trading along, which is similar to the current Manning Rule standard. In practice, a member organization could therefore impose terms and conditions on institutional accounts or customers with large orders. For example, a member organization could trade along or ahead of not held orders of institutional accounts.

In its Regulatory Notice, FINRA is soliciting comments on the type of disclosures that should be provided to institutional accounts or customers with large orders to advise them of the terms and conditions that would be imposed on their orders. In addition, FINRA is soliciting comments on whether institutional accounts or customers with large orders would need to provide affirmative written consent to such terms and conditions being imposed, or whether negative consent would be sufficient for a member organization to impose such terms and conditions. NYSE Regulation notes that if adopted, the proposed rule would change the current Rule 92(b) requirement that a member organization obtain either affirmative written consent or order-by-order consent before trading along with an institutional account or large order.

NYSE Regulation is requesting comments on whether the new rule should have an affirmative consent requirement, either a blanket one-time consent or order-by-order consent, or adopt a negative consent with disclosure approach. Specifically, NYSE Regulation requests that interested parties address any and all practical issues with respect to affirmative (one-time or order-by-order) consent regime versus negative consent with disclosure. For example, would it be feasible to adopt the affirmative consent approach for trading in all securities in all markets, and if not, why not? What is the cost versus benefit of an affirmative versus negative consent regime?

NYSE Regulation also notes that the proposed FINRA rule does not limit the types of transactions that a member organization may engage in when trading along with institutional accounts or large orders. This differs from Rule 92(b), which limits the types of transactions that a member organization enter when trading along with an institutional account or large orders to either a liquidating transaction, a bona fide hedge, or a bona fide arbitrage. NYSE Regulation proposes to adopt the proposed FINRA Rule 5320 standard for trading along with institutional accounts and large orders and therefore eliminate the restrictions of Rule 92(b).

NYSE Regulation further notes that proposed FINRA Rule 5320.01 adopts the definition of "institutional account" of FINRA Rule 4512 (NASD Rule 3110). This definition differs from the Exchanges' current definition of "institutional account" set forth in Rule 92.50. Unlike FINRA Rule 4512, Rule 92.50 does not include a natural person with total assets of at least \$50 million to be considered an "institutional account." NYSE Regulation invites comments on whether the Exchanges should adopt the FINRA definition of institutional account.

C. Proposed Rule 5320.03 (Riskless Principal Exception)

By adopting proposed FINRA Rule 5320, the Exchange believes that the current issues relating to the differences between the application of the Rule 92(c) riskless principal exception and the Manning Rule riskless principal exception would be mooted. For example, member organizations would no longer need to identify certain facilitation orders on behalf of an institutional account as a riskless principal transaction.

The Exchange notes, however, that proposed FINRA Rule 5320.03 requires FINRA members to submit a report, contemporaneously with the execution of a riskless principal facilitation order, that identifies the trade as riskless principal. In prior guidance, the NYSE announced a methodology for reporting riskless principal trades that included using the Exchange's Front End Systemic Capture ("FESC") system to report riskless principal transactions. See Information Memo 07-87, dated August 23, 2007. That reporting requirement has been delayed in light of these harmonization efforts. In the interim, a member organization routing riskless principal orders to the Exchange must have in place systems and controls that allow it to easily match and tie riskless principal executions at the Exchange to the underlying orders, and that it be able to provide this information to NYSE Regulation upon request. See Information Memo 08-27, dated May 12, 2008.

Pending approval of a filing to harmonize Rule 92 and the Manning Rule, the Exchanges would propose to the Commission to continue the suspension of the FESC reporting requirements. Note, however, that if the Exchanges adopt proposed FINRA Rule 5320.03, the Exchanges would still have a rule that requires member organizations to submit a report, contemporaneously with the execution of the facilitated order that identifies the trade as riskless principal. NYSE Regulation invites interested parties to comment on how such reporting requirements could be met at the Exchange, other than using the FESC system, as previously announced. For example, would reporting to the NYSE TRF be a viable solution?

D. Proposed Rule 5320.05 (Bona Fide Error Transaction Exceptions)

The proposed FINRA Rule 5320.05 provides for a bona fide error exception similar to that of NYSE Rule 92(d)(4). NYSE Regulation notes that the application of the proposed rule at the

Exchanges would be the same as Rule 92(d)(4) and the definition of a bona fide error is set forth in Exchanges Rule 134(g) and (h).

E. Proposed Rule 5320.06 (Minimum Price Improvement Standards) and 5320.07 (Order Handling Procedures)

Because of market structure differences, NYSE Regulation is soliciting comments on whether the Exchanges should adopt proposed FINRA Rule 5320.06, which concerns minimum price improvement standards, or 5320.07, which concerns order handling procedures. NYSE Regulation invites comments on whether the Exchanges should include these provisions as part of its customer order protection rule. Specifically, would the requirement to provide minimum price improvement have any unintended consequences on Floor or upstairs members?

IV. Staff Contacts

Questions regarding the proposed rule change may be directed to:

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