

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61168; File No. SR-FINRA-2009-090)

December 15, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Adopt FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) 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 December 10, 2009, 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) 2110-2 (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).

The text of the proposed rule change is available on FINRA’s Web site at <http://www.finra.org>, on the Commission’s Web site at <http://www.sec.gov>, at the principal office of FINRA, and at the Commission’s Public Reference Room.

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-2110-2 (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).

Background

IM-2110-2 generally prohibits a member from trading for its own account in an NMS stock, as defined in Rule 600(b)(47) of SEC Regulation NMS, or an OTC equity security (e.g.,

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).

OTCBB and pink sheets securities) at a price that is equal to or better than an unexecuted customer limit order in that security, unless the member immediately, in the event it trades ahead, executes the customer limit order at the price at which it traded for its own account or better.⁴

Similarly, Rule 2111 generally prohibits a member that accepts and holds a customer market order in a Nasdaq or exchange-listed security from trading for its own account at prices that would satisfy a customer market order, unless the firm immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or better. At present, Rule 2111 does not apply to OTC equity securities.

While there is no Incorporated NYSE Rule counterpart to IM-2110-2 and Rule 2111 (collectively referred to herein as “customer order protection” rules), New York Stock Exchange LLC (“NYSE”) Rule 92 imposes similar requirements on NYSE members in NYSE-listed securities. NYSE Rule 92 generally prohibits members or member organizations from knowingly entering proprietary orders ahead of, or along with, customer orders that are executable at the same price as the proprietary order.

As discussed below, FINRA is proposing several changes to the standards set forth in IM-2110-2 and Rule 2111 to simplify and clarify these rules, as well as create an industry standard that incorporates elements from existing FINRA and NYSE rules.

Integration of IM-2110-2 and Rule 2111

⁴ For example, if a member buys 100 shares of a security at \$10 per share while holding customer limit orders in the same security to buy at \$10 per share equaling, in aggregate, 1000 shares, the member is required to fill 100 shares of the customer limit orders at \$10 per share or better.

FINRA is proposing to integrate IM-2110-2 and Rule 2111 into a single rule (proposed Rule 5320) governing members' treatment of customer orders and to apply the new rule to all equity securities uniformly, other than the no-knowledge interpretation as detailed below. In addition to streamlining and simplifying the rules, the principal change resulting from the proposed combination of these rules is to extend the application of Rule 2111 to OTC equity securities. As noted above, Rule 2111 currently applies only to Nasdaq or exchange-listed securities, while IM-2110-2 applies to both NMS stocks and OTC equity securities. FINRA believes that the same concerns that arise with respect to trading ahead of limit orders in OTC equity securities also exist with respect to market orders and, therefore, an expansion of the Rule 2111 protections to those securities is appropriate.

Large Orders and Institutional Accounts

There are several exceptions to the customer order protection rules. Most notably, members are permitted to negotiate terms and conditions on the acceptance of certain large-sized orders (orders of 10,000 shares or more and greater than \$100,000 in value) and orders from institutional accounts as defined in NASD Rule 3110(c) (collectively referred to as "Institutional/Large-Sized Orders"). Such terms and conditions would permit the member to continue to trade along side or ahead of such customer orders if the customer agrees.

FINRA is proposing to modify the steps necessary for a member to avail itself of this exception for Institutional/Large-Sized Orders. Specifically, under the proposed rule, a member would be permitted to trade a security on the same side of the market for its own account at a price that would satisfy a customer order provided that the member provides clear and comprehensive written disclosure to each customer at account opening and annually thereafter that: (a) discloses that the member may trade proprietarily at prices that would satisfy the

customer order, and (b) provides the customer with a meaningful opportunity to opt in to the Rule 5320 protections with respect to all or any portion of its order(s).⁵

If a customer does not opt in to the Rule 5320 protections with respect to all or any portion of its order(s), the member may reasonably conclude that such customer has consented to the member trading a security on the same side of the market for its own account at a price that would satisfy the customer's order.⁶

In lieu of providing written disclosure to customers at account opening and annually thereafter, the proposed rule would permit members to provide clear and comprehensive oral disclosure to, and obtain consent from, a customer on an order-by-order basis, provided that the member documents who provided such consent and that such consent evidences the customer's understanding of the terms and conditions of the order. In addition, where a customer has opted in to the Rule 5320 protections, a member may still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the member documents

⁵ FINRA reminds members that, even where a customer has not opted in to the protections under proposed Rule 5320, member conduct must continue to be consistent with the guidance provided in the Notice to Members 05-51 (August 2005). In Notice to Members 05-51, FINRA, among other things, reminded members that adherence to just and equitable principles of trade as mandated by Rule 2010 "requires that members 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." See also NASD Rule 2320 (Best Execution and Interpositioning).

⁶ As is always the case, customers retain the right to withdraw consent at any time. Therefore, a member's reasonable conclusion that a customer has consented to the member trading along with such customer's order is subject to further instruction and modification from the customer.

who provided such consent and that such consent evidences the customer's understanding of the terms and conditions of the order.⁷

No-Knowledge Exception

Both the FINRA customer order protection requirements and NYSE Rule 92 have similar, but not identical, "no-knowledge" exceptions. Specifically, NYSE Rule 92, by its terms, is limited to those circumstances where the firm knowingly trades ahead of its customer. Accordingly, under NYSE Rule 92, a firm may trade ahead of a customer order as long as the person entering the proprietary order has no knowledge of the unexecuted customer order.⁸ Similarly, FINRA previously established a "no-knowledge" interpretation to its customer order protection requirements. Under this interpretation, if a firm implements and utilizes an effective system of internal controls, such as appropriate information barriers that operate to prevent a non-market-making proprietary desk from obtaining knowledge of customer orders held at the firm's market-making desk, those "walled off" non-market-making proprietary desks are permitted to trade at prices that would satisfy the customer orders held by the market-making

⁷ While a firm relying on this or any exception must be able to proffer evidence of its eligibility for and compliance with the exception, FINRA believes that when obtaining consent on an order-by-order basis, members must, at a minimum, document not only the terms and conditions of the order (e.g., the relative price and size of the allocated order/percentage split with the customer), but also the identity of the person at the customer who approved the trade-along request. For example, the identity of the person must be noted in a manner that will enable subsequent contact with that person if a question as to the consent arises (i.e., first names only, initials, and nicknames will not suffice).

⁸ Under NYSE Rule 92.10, a member or employee of a member or member organization is "presumed to have knowledge of a particular customer order unless the member organization has implemented a reasonable system of internal policies and procedures to prevent the misuse of information about customer orders by those responsible for entering proprietary orders."

desk without any requirement that such proprietary executions trigger an obligation to fill pending customer orders at the same price.⁹

FINRA's no-knowledge interpretation was established at a time when the majority of retail order flow was handled by the firm's market-making desk and viewed as a critical source of liquidity for customer orders. As a result, permitting firms to wall off the market-making desk at that time was viewed as untenable fragmentation of liquidity to the detriment of retail customers. However, as a result of changes in market structure and general order routing protocols discussed below, FINRA is proposing to expand and codify the current no-knowledge interpretation, consistent with NYSE Rule 92, to include the market-making desk with respect to NMS stocks.

Today, many firms handle retail-sized customer orders in NMS stocks on an automated basis, separate and apart from the firm's proprietary trading desks, including the market-making desk, in which such orders are routed through automated systems that search out the market centers offering pools of liquidity that offer immediate execution at the probable best available prices. Accordingly, some firms have determined to structure their order handling practices to "wall off" customer order flow from their market-making and other proprietary desks.¹⁰ FINRA does not believe that requiring walled-off trading desks to integrate orders for compliance with

⁹ See Notices to Members 95-43 (June 1995), 03-74 (November 2003) and 06-03 (January 2006).

¹⁰ FINRA notes that such a determination must be made in conformance with FINRA's best execution requirements. FINRA's best execution requirements under NASD Rule 2320(a) generally require that, when executing a customer transaction, members use reasonable diligence to ascertain the best market for the subject security and buy or sell in that market so that the price to the customer is as favorable as possible under prevailing market conditions. FINRA requested comment on proposed changes to NASD Rule 2320 in Regulatory Notice 08-80 (December 2008). These changes would not impact the fundamental operation of NASD Rule 2320(a).

proposed Rule 5320 will necessarily enhance the execution quality for these orders in today's environment. Thus, with respect to NMS stocks, FINRA believes that expanding the current no-knowledge interpretation to include market-making desks is appropriate and better reflects the realities of the current trading environment.

However, FINRA is not proposing to similarly expand the no-knowledge interpretation with respect to OTC equity securities because the same types of changes in market structure and order handling practices have not occurred in that market; OTC equity securities are generally not traded at market centers with the same depth of liquidity and are not as susceptible to automated routing for best execution. Accordingly, the current no-knowledge standard, as set forth in prior Notices to Members, would continue to apply to OTC equity securities.

To the extent a firm structures its order handling practices in NMS stocks to "wall off" customer order flow from its market-making desks, FINRA is proposing to require the firm to disclose that fact in writing to its customers. This disclosure would include a description of the manner in which customer orders are handled and the circumstances under which the firm may trade proprietarily at its market-making desk at prices that would satisfy a customer order. The proposed disclosure would be required at account opening and on an annual basis thereafter and may be combined with the disclosure and negative consent statement permitted in connection with the proposed Institutional/Large-Sized Order exception.

In addition, firms that choose to structure their order handling practices in NMS stocks to "wall off" customer order flow from their market-making desks must obtain and use a unique market participant identifier (MPID) for the market-making desk. For example, if customer order flow is sent directly to an agency desk and is "walled-off" from the firm's market-making desk, those two desks must use different MPIDs.

Odd Lot and Bona Fide Error Exception

FINRA proposes applying the customer order protection requirements to all customer orders (currently there is a blanket exclusion for odd lots), but would provide an exception for a firm's proprietary trade that (1) offsets a customer odd lot order (i.e., an order less than one round lot, which is typically 100 shares); or (2) corrects a bona fide error. With respect to bona fide errors, member firms would be required to demonstrate and document the basis upon which a transaction meets the bona fide error exception. For purposes of this rule, the definition of a "bona fide error" is as defined in SEC Regulation NMS's exemption for error correction transactions.¹¹

Trading Outside Normal Market Hours

FINRA proposes expanding the customer order protection requirements to apply at all times that a customer order is executable by the member, even outside the period of normal market hours (9:30 a.m. to 4:00 p.m.). Currently, the customer order protection requirements apply only during normal market hours and after hours (4:00 p.m. to 6:30 p.m.). Thus, customers would have the benefit of the customer order protection rules at all times where such order is executable by the member firm, subject to any applicable exceptions.

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.

¹¹ Securities Exchange Act Release No. 55884 (June 8, 2007), 72 FR 32926 (June 14, 2007) (Order Exempting Certain Error Correction Transactions from Rule 611 of Regulation NMS under the Securities Exchange Act of 1934).

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹² 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. FINRA believes that adopting the proposed rules as part of the Consolidated FINRA Rulebook will continue to protect investors by defining important parameters by which member firms must abide when trading proprietarily while holding customer limit and market orders.

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 09-15 (March 2009). A copy of the Regulatory Notice is attached as Exhibit 2a. FINRA received five comment letters in response to the Regulatory Notice and commenters generally supported the proposed provisions.¹³ A list of the comment letters received is attached as Exhibit 2b, and copies of each comment letter received are attached as Exhibit 2c.

¹² 15 U.S.C. 78o-3(b)(6).

¹³ Letter from Daniel C. Rome, Esq., General Counsel, Taurus Compliance Consulting, LLC, to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, dated April 22, 2009; letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, dated April 24, 2009 ("FIF"); letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Senior Vice President and Corporate Secretary,

Commenters generally supported FINRA’s effort to integrate the limit order protection rule and the market order protection rule into a single rule; update and 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.

(a) Integration of Limit Order Protection and Market Order Protection into a Single Rule

Commenters supported a uniform industry standard and the proposal to apply market order protection to trading in OTC equity securities. While some firms asked that FINRA consider the costs and time needed for implementation (e.g., FIF requested a nine month implementation period), others recommended that FINRA move forward without delay with the rule proposal (e.g., SIFMA).

(b) Exception to Permit Trading Ahead of Certain Large Orders/Institutional Accounts

Commenters supported FINRA’s approach because it provides members with a measure of flexibility as to what method of disclosure and consent is appropriate, thereby simplifying compliance, while also providing adequate customer protection. For example, SIFMA believes that negative consent plus disclosure adequately protects customers, while affirmative consent is unduly resource-intensive and burdensome.

(c) Expansion of the No-Knowledge Exception to Include Market-Making Desks

Commenters supported the expansion of the “no-knowledge” exception to trading in NMS stocks at market-making desks. SIFMA and FIF recommended allowing (but not requiring) firms to use separate MPIDs. SIFMA argued that introducing numerous MPIDs may

FINRA, dated April 30, 2009 (“SIFMA”); letter from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets Inc., to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, dated June 12, 2009 (“Pink OTC”), and letter from Jack Rubens to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, dated September 14, 2009.

result in complex and expensive reporting and may increase the likelihood of operational and technical glitches in such reporting. Thus, SIFMA prefers a policies and procedures approach to provide individual firms with the flexibility to address surveillance in the best way for each particular firm.

Regarding the expansion of the “no-knowledge” exception to include market-making desks for NMS stocks, SIFMA and Pink OTC support the proposal but also argue that the proposal should also include trading in OTC equity securities. SIFMA and Pink OTC also argue that the differences in these two markets do not justify applying the rule differently and further argues that, where there are differences, the OTC market is evolving to the structure of NMS stocks.

SIFMA and Pink OTC believe that extending the no-knowledge exception to cover OTC equity securities would provide firms with the flexibility to adapt their order routing practices as changes occur without sacrificing customer protection and further argue that the adoption of two different standards is inconsistent with the stated intentions of harmonization between FINRA and NYSE, which is to bring consistency. Pink OTC additionally believes that adoption of a harmonious standard for NMS stocks and OTC equity securities would facilitate compliance and programming efficiencies.

(d) Extension of the Application of the Rule to Trading During Extended Hours

SIFMA is concerned about the potential impact on systems and procedures if proposed Rule 5320 applied to extended-hours trading. SIFMA argues that customers who trade in extended hours are generally sophisticated and should be treated like institutional and large orders, even if smaller or submitted by an individual.

(e) Other Comments

In response to the Regulatory Notice, Pink OTC also commented on aspects of the current Manning rules that were not proposed to be amended; particularly, the quantity of the minimum price improvement increments (MPI), as well as several trading scenarios with respect to which they believed that the timing for the triggering of the MPI should be altered.

Pink OTC argued that the proposed rules should be modified to provide market makers with incentives to maintain priced quotations in order to foster pricing competition among all market participants and promote the institution and maintenance of liquid markets in OTC equity securities. Specifically, Pink OTC recommended that (i) customer orders qualify for price improvement generally only where defined quotation sizes are used; (ii) market makers should be required to provide price improvement only where the customer order is received before the firm has begun the process of executing a trade for its own account; and (iii) publicly displayed proprietary quotes should be afforded time priority over customer orders that are received after a market-maker's proprietary quote is published.

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

Within 35 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 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. In particular, the Commission notes that, under the proposal, if a member provides disclosure to the customer at account opening and annually thereafter, Institutional/Large-Sized Orders would not be subject to Manning protection, unless the customer affirmatively opted in to the proposed Rule 5320. The Commission specifically requests comment on whether such negative consent requirement is appropriate and sufficiently protects institutional accounts and customers with large orders. Should affirmative, written consent be required instead? Further, is disclosure at account opening and annually thereafter sufficient to protect customer orders? 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-2009-090 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-2009-090. 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 Web site (<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 inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of the 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-2009-090 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.¹⁴

Florence E. Harmon
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).