

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-60635; File No. SR-FINRA-2007-024)

September 8, 2009

Self-Regulatory Organizations; Financial Industry Regulatory, Inc.; Order Approving Proposed Rule Change as Modified by Amendment No. 1 Thereto Amending Rule 2320 Regarding Best Execution and Interpositioning

On November 27, 2007, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend NASD Rule 2320, Best Execution and Interpositioning. On April 13, 2009, FINRA filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on April 24, 2009.<sup>3</sup> The Commission received no comments regarding the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

In its filing, FINRA proposed to amend NASD Rule 2320, which governs members’ obligations regarding best execution and interpositioning.<sup>4</sup> Rule 2320(a) provides that, in any transaction for or with a customer or a customer of another broker-dealer, a member must use “reasonable diligence to ascertain the best market for the subject security,” so that the resulting price to the customer is “as favorable as possible under prevailing market conditions.”<sup>5</sup> A number of factors will be considered in determining whether the member exercised reasonable diligence,

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 59788 (April 17, 2009), 74 FR 18777 (“Notice”).

<sup>4</sup> NASD Rule 2320 paragraph (a) governs best execution and paragraph (b) governs interpositioning.

<sup>5</sup> See NASD Rule 2320(a).

including the character of the market for the security, the size and type of the transaction, and the terms and conditions of the order that resulted in the transaction.<sup>6</sup>

Currently, Rule 2320(b) prohibits a member from interposing a third party between the member and the best available market for a security, unless the member “can demonstrate that to his knowledge at the time of the transaction the total cost or proceeds of the transaction . . . was better than the prevailing inter-dealer market for the security.”<sup>7</sup> In addition, a member’s obligations to its customer “are generally not fulfilled” under the current Rule when interposing a third party, unless the member can show that the interpositioning “reduced the costs of the transactions to the customer.”<sup>8</sup>

With this rule change, FINRA proposed to apply the standards governing best execution, which are set forth in Rule 2320(a), to interpositioning. As such, a member interposing a third party will have to use “reasonable diligence to ascertain the best market for the subject security,” so that the resulting price to the customer is “as favorable as possible under prevailing market conditions.”<sup>9</sup> FINRA also proposed to make conforming amendments to other NASD and FINRA rules to reflect the re-designation of Rule 2320.

The Commission has carefully reviewed the proposed rule change and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a registered securities association<sup>10</sup> and, in particular, Section 15A(b)(6) of

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<sup>6</sup> Id.

<sup>7</sup> See NASD Rule 2320(b).

<sup>8</sup> Id.

<sup>9</sup> See NASD Rule 2320(a).

<sup>10</sup> In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

the Act,<sup>11</sup> which requires that FINRA rules 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.

In stating that interpositioning generally does not fulfill a member's obligation to its customer unless that interpositioning "reduced the costs of the transactions to the customer," the current rule contains a presumption against interpositioning.<sup>12</sup> FINRA stated in its filing that the presumption is overbroad and may not accurately reflect the realities of the current market. The Commission understands FINRA's argument that the rule, as currently written, may be overbroad. There have been a number of changes in the markets since the time the rule was adopted by the NASD in 1968. However, the Commission believes that there continue to be opportunities for unscrupulous participants in the marketplace to interposition third parties in a securities transaction between themselves and their customers to the disadvantage of those customers.<sup>13</sup> The Commission expects FINRA, when it finds evidence of interpositioning by members that was detrimental to the customer, to charge member firms or associated persons, as appropriate, with violations of its rules.

The Commission notes that its approval of this rule change is not an indication that interpositioning is no longer an issue. Rather, it is meant to reflect changes in the market place that

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<sup>11</sup> 15 U.S.C. 78o-3(b)(6).

<sup>12</sup> See, e.g., In re Thomson & McKinnon, Securities Exchange Act Release No. 8310 (May 8, 1968). In that proceeding, an NASD member firm interposed broker-dealers between itself and the best available market, and the added transaction cost was borne by its customers. The Commission found that, "[i]n view of the obligation of a broker to obtain the most favorable price for his customer, where he interposes another broker-dealer between himself and a third broker-dealer, he prima facie has not met that obligation and he has the burden of showing that the customer's total cost or proceeds of the transaction is the most favorable obtainable under the circumstances."

<sup>13</sup> See, e.g., In re Andrew P. Gonchar and Polyviou T. Polyviou, Securities Exchange Act Release No. 34-60506 (August 14, 2009).

have occurred since 1968 when the rule was adopted.<sup>14</sup> The Commission notes that, even with this rule change, the cost to the customer under the proposed rule will “remain a crucial factor in determining whether a member has fulfilled its best execution obligations under Rule 2320,” including transactions involving interposed third parties.<sup>15</sup> The Commission also notes that interpositioning “that is unnecessary or violates a member’s general best execution obligations – either because of unnecessary costs to the customer or improperly delayed executions – would still be prohibited.”<sup>16</sup> In this respect, the Commission takes comfort from FINRA’s representations that interpositioning that harms a customer violates NASD Rule 2440 and FINRA Rule 2010.<sup>17</sup>

The proposed rule will thus continue to prohibit interpositioning that adversely affects the customer, and the cost to the customer will remain a central part of that determination. The Commission expects FINRA to diligently pursue such conduct by members.<sup>18</sup>

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<sup>14</sup> See Notice, supra note 3, at 18778.

<sup>15</sup> Id. at 18778.

<sup>16</sup> Id. at 18779.

In addition to the proposed rule language, other FINRA and NASD rules would continue to govern the handling of customer orders. In particular, FINRA Rule 2010 requires that members observe high standards of commercial honor and just and equitable principles of trade, and NASD Rule 2440 requires that members charge fair prices and commissions in their dealings with customers.

<sup>17</sup> Id. at 18778 n.4.

<sup>18</sup> See In re Andrew P. Gonchar and Polyvvious T. Polyviou, supra note 13.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-FINRA-2007-024), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>19</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).