

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60851; File No. SR-FINRA-2009-068)

October 21, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to FINRA's Rules Governing Clearly Erroneous Executions

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 October 19, 2009, Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("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 Rule 11890, IM-11890-1, and IM-11890-2 into the Consolidated FINRA Rulebook as part of a new FINRA Rule 11890 Series governing clearly erroneous transactions and to amend these rules as part of a market-wide effort designed to provide transparency and finality with respect to clearly erroneous executions.

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, 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 that NASD Rule 11890, IM-11890-1, and IM-11890-2 be moved into the Consolidated FINRA Rulebook as part of a new FINRA Rule 11890 Series governing clearly erroneous transactions.⁴ FINRA is also proposing to amend these rules as part of a market-wide effort designed to provide transparency and finality with respect to clearly erroneous executions.⁵ This effort seeks to achieve consistent results for participants across U.S.

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).

⁴ FINRA will transfer the remaining rules in the Uniform Practice Code into the Consolidated FINRA Rulebook in a separate filing.

⁵ See Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving SR-NYSEArca-2009-36).

equities exchanges while maintaining a fair and orderly market, protecting investors, and protecting the public interest. Unlike the rules of the U.S. equities exchanges, FINRA's rules also address clearly erroneous executions in OTC Equity Securities.⁶ NASD Rule 11890 currently provides that, in the event of a disruption or malfunction related to the use or operation of any quotation, communication, or trade reporting system owned or operated by FINRA, or under extraordinary market conditions, designated officers of FINRA can review an over-the-counter ("OTC") transaction arising out of or reported through any such quotation, communication, or trade reporting system, and may declare the transaction null and void or modify the terms if any such officer determines that the transaction is clearly erroneous or that such action is necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest. IM-11890-1 and IM-11890-2 address rulings made by FINRA and the UPC Committee pursuant to NASD Rule 11890 and the review of those rulings.

NASD Rule 11890 provides important safeguards against market disruptions caused by trader errors, system malfunctions, or other extraordinary events that result in erroneous executions affecting multiple market participants and/or securities. NASD Rule 11890 has been used both with respect to events affecting a single stock, such as an extraordinary erroneous order causing a large number of trades involving multiple market participants in a single stock (single stock events), and events affecting multiple stocks, such as a system malfunction resulting in a more widespread problem (multi-stock events).

In addition to the substantive changes to the clearly erroneous provisions described below, the proposed rule change structurally alters the provisions as well. FINRA is proposing

⁶ For purposes of the proposed rule change, the term "OTC Equity Security" has the same meaning as defined in FINRA Rule 6420, except that the term does not include any equity security that is traded on any national securities exchange.

to create a new clearly erroneous series of rules: FINRA Rule Series 11890. Under this umbrella would be (1) a general provision (Rule 11891) with accompanying Supplementary Material; (2) a rule governing clearly erroneous determinations for transactions in exchange-listed securities (Rule 11892) with accompanying Supplementary Material; (3) a rule governing clearly erroneous determinations for transactions in OTC Equity Securities (Rule 11893) with accompanying Supplementary Material; and (4) a rule governing review of FINRA staff determinations by the UPC Committee (Rule 11894).

Definition & General Guidelines

The proposed rule change creates Rule 11891, which defines the term “clearly erroneous” for purposes of the new FINRA Rule 11890 Series. The proposed rule specifies that “the terms of a transaction are ‘clearly erroneous’ when there is an obvious error in any term, such as price, number of shares, or other unit of trading, or identification of the security.” The language in the rule is based on the definition in the recently approved amendments to NYSE Arca Rule 7.10.⁷

The proposed rule change also includes four proposed paragraphs of Supplementary Material to Rule 11891. Proposed Supplementary Material .01 rennumbers current NASD IM-11890-1 regarding a member’s failure to abide by FINRA or UPC Committee rulings. Proposed Supplementary Material .02 and .03 set forth the general standards applicable to clearly erroneous determinations and clarify that FINRA generally considers a transaction to be clearly erroneous when there is a systemic problem that involves large numbers of parties or trades, or conditions where it would be in the best interests of the market. Further, extraordinary market conditions may include situations where an extraordinary event has occurred or is ongoing that has had a material effect on the market for a security traded over-the-counter or has caused major

⁷ See Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving SR-NYSEArca-2009-36).

disruption to the marketplace. Supplementary Material .02 also emphasizes that members are responsible for ensuring that the appropriate price and type of order are entered into FINRA systems.

Finally, proposed Supplementary Material .04 specifically addresses suspicious trading activities such as unauthorized trading activity or attempts to manipulate stock prices by illegally gaining access to legitimate accounts or opening new accounts using false information (often referred to as “account intrusion”). Although FINRA continues to be concerned about protecting markets from unauthorized or illegal activity like account intrusion that could disrupt a fair and orderly market, FINRA believes that its clearly erroneous authority does not extend to such suspicious trading activities. Rather, FINRA believes such activities relate to allegations of fraud and fall outside the scope of the clearly erroneous rules.⁸ Consequently, FINRA is proposing the Supplementary Material to clarify this position while also noting that members should routinely review the adequacy of their internal controls and ensure that appropriate system safeguards are in place to minimize or eliminate the potential for account intrusion.

Review of Transactions in Exchange-Listed Securities

Proposed Rule 11892 and its Supplementary Material set forth the standards FINRA uses to determine whether a transaction in an exchange-listed security is clearly erroneous. FINRA believes that coordinating with other self-regulatory organizations with the goal of having consistency and transparency regarding the clearly erroneous process is important to the

⁸ In approving recent amendments to Nasdaq’s clearly erroneous rule, the Commission noted that, “[g]iven the fact that the Clearly Erroneous Rule is designed to address trades made in error and the more difficult factual analysis presented by expanding the rule’s application beyond obvious errors,” it was appropriate for Nasdaq to “retain the original scope of the [clearly erroneous] rule” rather than extend the rule to address account intrusion. See Securities Exchange Act Release No. 57826 (May 15, 2008), 73 FR 29802 (May 22, 2008).

marketplace and to investors. Consequently, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA Trade Reporting Facility (“TRF”) or Alternative Display Facility (“ADF”), FINRA will generally follow the determination of a national securities exchange to break a trade (or multiple trades) when that national securities exchange has broken one or more trades at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be consistent with market integrity and investor protection. When multiple national securities exchanges have related trades, FINRA will leave a trade(s) unbroken when any of those national securities exchanges has left a trade(s) unbroken at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be inconsistent with market integrity and investor protection.⁹

With respect to OTC transactions in exchange-listed securities for which there is no corresponding or related on-exchange trading activity, FINRA believes that the best approach in determining whether to declare transactions clearly erroneous is to follow the exchanges’ criteria when making a clearly erroneous determination. In this sector of the market, FINRA believes that consistency in application of clearly erroneous authority across markets is critical to ensure that one investor does not receive disparate treatment based solely on the ultimate execution or reporting venue of his or her order. Consequently, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA TRF or the ADF, but for which there is no corresponding or related on-exchange trading activity, FINRA will generally make its

⁹ See proposed Rule 11892, Supplementary Material .01.

own clearly erroneous determination.¹⁰ However, to ensure that transactions in exchange-listed securities are treated consistently regardless of where the trade is executed (i.e., on an exchange or OTC), proposed Rule 11892 replicates the numerical thresholds used by the exchanges to determine whether a transaction is eligible for consideration as clearly erroneous. The proposed rule also establishes provisions for the use of alternative reference prices in unusual circumstances, additional factors that FINRA may consider when making a clearly erroneous determination, and numerical guidelines applicable to volatile market opens. Each of these provisions is modeled on similar provisions in the recently approved amendments to NYSE Arca Rule 7.10.¹¹

Review of Transactions in OTC Equity Securities

Currently, NASD Rule 11890 governs FINRA's clearly erroneous process for both exchange-listed securities and OTC Equity Securities. The core purpose of the clearly erroneous rules is to grant FINRA authority to determine that a transaction is clearly erroneous with a goal of maintaining market integrity by declaring a transaction (or multiple transactions, if necessary) to be null and void if the terms of the trade are clearly out of line with objective market conditions for the security.¹² FINRA is proposing to apply its clearly erroneous authority somewhat differently depending on whether the security is listed on a national securities

¹⁰ Unlike the NYSE Arca rule regarding clearly erroneous determinations, the FINRA rules do not allow members to initiate reviews of transactions. All reviews conducted by FINRA are conducted on FINRA's own motion.

¹¹ See Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving SR-NYSEArca-2009-36).

¹² NASD Rule 11890 currently gives FINRA officers the authority to modify the terms of a transaction, in addition to declaring the transaction null and void. To conform FINRA's authority to the other exchanges' in the context of clearly erroneous determinations, FINRA is proposing to eliminate its ability to modify a clearly erroneous execution. See id.

exchange or is an OTC Equity Security. For that reason, FINRA is proposing to create separate rules for the treatment of exchange-listed securities, which would be governed by Rule 11892, and OTC Equity Securities, which would be governed by Rule 11893.

Proposed Rule 11893 is structured similarly to the provisions for transactions in exchange-listed securities under proposed Rule 11892, including numerical guidelines, the use of alternative reference prices in unusual circumstances, and additional factors FINRA officers may consider when making a clearly erroneous determination. However, as is the case today, the proposed numerical guidelines for transactions in OTC Equity Securities are not the same as the guidelines used for exchange-listed securities. The proposed rule change would codify the numerical guidelines currently used by FINRA to determine whether a transaction is eligible for clearly erroneous consideration. In some instances, for example, the percentage deviations set forth in the numerical guidelines are based on a sliding scale where the maximum percentage deviation applies to the lower execution price in the range and the minimum percentage deviation applies to the higher execution price in the range. The sliding scale is applied in a generally linear fashion (i.e., prices at the lower end of the reference price range are generally assessed at the higher percentage range) and is intended to smooth the percentage changes from tier to tier and allow for more gradual deviations. Because the sliding scale is not applied on a strictly linear basis, FINRA has more discretion in applying the guidelines for executions within the reference price range rather than being strictly a calculation of percentages.

The following chart summarizes the proposed Numerical Guidelines for clearly erroneous determinations for OTC Equity Securities:

Reference Price	Numerical Guidelines (Subject
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	Transaction's Percentage Difference from the Reference Price)
\$0.9999 and under	20%
\$1.0000 and up to and including \$4.9999	Low end of range minimum 20% - High end of range minimum 10%
\$5.0000 and up to and including \$74.9999	10%
\$75.0000 and up to and including \$199.9999	Low end of range minimum 10% - High end of range minimum 5%
\$200.0000 and up to and including \$499.9999	5%
\$500.0000 and up to and including \$999.9999	Low end of range minimum 5% - High end of range minimum 3%
\$1,000.0000 and over	3%

For example, a transaction executed at \$1.5000 that deviates by more than \$0.30 (or 20%) from the prevailing market price may be eligible for cancellation as “clearly erroneous”; whereas a

transaction executed at \$4.5000 that deviates by more than \$0.45 (or 10%) from the prevailing market price may be eligible for cancellation as “clearly erroneous.” The provisions in proposed Rule 11893 regarding alternative reference prices and additional factors are substantially similar to those set forth in Rule 11892 for exchange-listed securities.

FINRA is also proposing to adopt Supplementary Material to Rule 11893 to emphasize that FINRA has historically exercised its clearly erroneous authority in very limited circumstances, in particular with respect to OTC Equity Securities. This more narrow approach for OTC Equity Securities is due to the differences in the OTC equity and exchange-listed markets, including the lack of compulsory information flows in the OTC equity market that come as a result of the listing process and the fact that aberrant trading in the OTC market is often due to issues other than systems problems or extraordinary events. The Supplementary Material explains that FINRA does not expect to use its clearly erroneous authority in most situations; rather, FINRA expects the parties to settle any dispute privately.

Review Procedures

Initial Determinations

As noted above, FINRA is proposing to remove language that currently allows a FINRA officer to modify one or more of the terms of a transaction under review. Under the proposed rules, the FINRA officer will only have the authority to break the trades. This proposed change is intended to conform with the rules of other exchanges and attempts to remove the subjectivity from the rule that is necessitated by an adjustment. The proposed rule governing initial determinations remains substantially similar to that in current NASD Rule 11890. An Executive Vice President of FINRA’s Market Regulation Department or Transparency Services Department, or any officer designated by such Executive Vice President, may, on his or her own

motion, review any transaction arising out of or reported through any FINRA facility. With respect to determinations involving transactions in exchange-listed securities, absent extraordinary circumstances, the officer shall take action generally within 30 minutes after becoming aware of the transaction. When extraordinary circumstances exist, any such action of the officer must be taken no later than the start of trading on the day following the date of execution(s) under review. With respect to determinations involving transactions in OTC Equity Securities, a FINRA officer must make a determination as soon as possible after becoming aware of the transaction, but in all cases by 3:00 p.m., Eastern Time, on the next trading day following the date of the transaction at issue. If a FINRA officer declares any transaction null and void, FINRA will notify each party involved in the transaction as soon as practicable, and any party aggrieved by the action may appeal such action in accordance with Rule 11894, unless the officer making the determination also determines that the number of the affected transactions is such that immediate finality is necessary to maintain a fair and orderly market and to protect investors and the public interest.

Appeals

FINRA is proposing to codify in a separate rule (Rule 11894) the provisions governing the appeal to the UPC Committee of a FINRA officer's determination to declare an execution clearly erroneous.¹³ IM-11890-2, which concerns review by panels of the UPC Committee, will be incorporated into the text of the new rule. Under the rule, an appeal must be made in writing and must be received by FINRA within thirty minutes after the person making the appeal is given the notification of the determination being appealed. With respect to appeals regarding exchange-listed securities, determinations by the UPC Committee will be rendered as soon as

¹³ As the rule makes clear, a FINRA officer's determination not to break a trade is not appealable.

practicable, but generally, on the same trading day as the execution(s) under review. On requests for appeal received after 3:00 p.m., Eastern Time, a determination will be rendered as soon as practicable, but in no case later than the trading day following the date of the execution(s) under review. With respect to appeals regarding OTC Equity Securities, determinations by the UPC Committee will be rendered as soon as practicable, but in no case later than two trading days following the date of the execution(s) under review.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁴ 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 guidelines to explain the application of the clearly erroneous process will provide clarity and consistency to the marketplace. In addition, FINRA believes if consistent standards are applied to this process across markets, then greater efficiency can be reached.

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.

¹⁴ 15 U.S.C. 78q-3(b)(6).

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments were neither solicited nor received.

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. 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-2009-068 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-2009-068. 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, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. 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-2009-068 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.¹⁵

Florence E. Harmon
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).