

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63885; File No. SR-FINRA-2010-055)

February 10, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order
Disapproving Proposed Rule Change to Amend FINRA Rule 6140 (Other Trading Practices)

I. Introduction

On October 29, 2010, 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” or “Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend FINRA Rule 6140, Other Trading Practices. The proposed rule change was published for comment in the Federal Register on November 12, 2010.³ The Commission received two comments on the proposal.⁴ On December 21, 2010, the Commission extended the time period in which to either approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change, to February 10, 2011.⁵ On January 24, 2011, FINRA submitted a response letter to the comments.⁶ This order disapproves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 63256 (November 5, 2010), 75 FR 69503 (“Notice”).

⁴ See Letters from Gary S. Sheller, CFP, Sheller Financial Services, dated November 24, 2010 (“Sheller Letter”); and Michael S. Nichols, Ph.D., Principal/Financial Advisor, Cutter Advisors Group, dated November 29, 2010 (“Cutter Letter”).

⁵ See Securities Exchange Act Release No. 63582 (December 21, 2010), 75 FR 81704 (December 28, 2010).

⁶ See Letter to Elizabeth M. Murphy, Secretary, Commission, from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA, dated January 24, 2011 (“FINRA Response Letter”).

II. Description of the Proposal

FINRA Rule 6140 provides that FINRA members may, but are not obligated to, accept stop orders in NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS.⁷ In addition, FINRA Rule 6140 provides that a stop order becomes a market order, or a stop limit order becomes a limit order, when a transaction takes place at or above the stop price (in the case of a buy stop order) or at or below the stop price (in the case of a sell stop order).⁸ Thus, under FINRA Rule 6140, a stop order cannot be triggered by the publication of a quotation at the stop price, but only by a transaction.⁹ FINRA proposes to eliminate these provisions governing the handling of stop orders in their entirety.

In support of its proposal to eliminate entirely from its rules those provisions governing the handling of stop orders, FINRA states that its members believe quotations may be a better indicator of the current price of a security than transactions, and have requested that FINRA provide members the flexibility to determine whether the trigger of a stop order will be based on transactions or quotations at the stop price. FINRA represents that its rules do not typically define the parameters of the various order types that members may accept and that FINRA believes that members should have the ability to define the triggering event for stop orders as well as to design their systems consistent with such determination. In addition, FINRA notes that it expects that, irrespective of whether a transaction or quotation is used as the trigger for a customer stop order, each member will apply the approach consistently firm-wide to all customer orders and fully disclose its practice to its customers.

⁷ See FINRA Rule 6140(h) and (i).

⁸ See FINRA Rule 6140(h).

⁹ See FINRA Rule 6140(h) and (i).

Finally, FINRA proposes to relocate the definition of “initial public offering” from Rule 6220 (Definitions) to Rule 6130 (Transactions Related to Initial Public Offerings). FINRA proposes no substantive changes to this definition.

III. Summary of Comment Letters and FINRA’s Response

The Commission received two comment letters objecting to the proposed rule change. The commenters generally were concerned with the use of quotations as a trigger for stop orders.¹⁰ One commenter believed that the triggering event for a stop order should be a transaction, and expressed concern that activating a stop order “based solely upon a bid opens the process to manipulation by those inclined to do so by flashing bids during market turbulence.”¹¹ In response, FINRA notes that FINRA Rule 5210 already prohibits the publication of a quotation that is not bona fide, and therefore the practice of flashing quotations for the sole purpose of activating a stop order, without the intention of trading at the price and volume quoted, is impermissible.¹²

The other commenter expressed concern that investors and financial advisors would not know whether the triggering event was a quote or a trade, and believed that investors would have a legitimate complaint if their stop order was triggered by a quote and there was no evidence it ever traded at that price.¹³ FINRA responds that it does not believe that it is appropriate at this time for FINRA to dictate the definitions for the order types offered by a member to its customers, and notes that numerous member firms have concluded that quotes are the more

¹⁰ See Cutter Letter and Sheller Letter, supra note 4.

¹¹ See Sheller Letter, supra note 4.

¹² See FINRA Letter, supra note 6, at p. 2.

¹³ See Cutter Letter, supra note 4.

appropriate triggering event for stop orders. FINRA believes that each member should be permitted to determine whether it will use quotes or transactions to trigger stop orders, provided that the member's approach is disclosed to its customers and is consistently applied.

IV. Discussion

Under section 19(b)(2)(C) of the Act, the Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to such organization.¹⁴ The Commission shall disapprove a proposed rule change if it does not make such a finding.¹⁵

After careful consideration, the Commission does not find that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.¹⁶ In particular, the Commission does not find that the proposed rule change is consistent with Section 15A(b)(6) of the Act, which requires that the rules of a national securities association be designed, among other things, "to prevent fraudulent

¹⁴ See 15 U.S.C. 78s(b)(2)(C)(i).

¹⁵ See 15 U.S.C. 78s(b)(2)(C)(ii); see also 17 CFR 201.700 (b)(3) ("The burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder ... is on the self-regulatory organization that proposed the rule change ... A mere assertion that the proposed rule change is consistent with those requirements ... is not sufficient.") The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding. See 17 CFR 201.700 (b)(3). Any failure of a self-regulatory organization to provide the information elicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder that are applicable to the self-regulatory organization. Id.

¹⁶ In disapproving the 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).

and manipulative acts and practices, to promote just and equitable principles of trade ... and, in general, to protect investors and the public interest.”¹⁷

FINRA proposes to delete in its entirety the provisions of Rule 6140 relating to the handling of stop orders in NMS stocks by member firms. Those provisions currently require that stop orders offered by member firms be triggered (i.e., become a market order or limit order) by a transaction in the security. Accordingly, this requirement should be providing customers certainty with respect to the operation of a key element of their stop orders.

By proposing to eliminate this provision, FINRA effectively would allow member firms to offer stop orders to customers that are triggered by a transaction, a quote or another mechanism altogether. While FINRA, in its “Statement of the Purpose” of the proposed rule change, notes that it “expects” each member to apply its approach to stop orders consistently and fully disclose its practice to its customers, FINRA has not clearly made this expectation enforceable by requiring consistency and customer disclosure in its rules.

The Commission acknowledges that some may believe a quotation is a better trigger mechanism for stop orders than a transaction, and there may be good reasons for allowing FINRA to provide flexibility for this in its rules. FINRA, however, has not articulated any such reasons. In addition, the Commission believes that, if FINRA rules were to permit members flexibility in the types of stop orders they offer, those rules should clearly require, at a minimum, that the member disclose to customers the type of stop order it offers. The Commission believes the regulatory framework should promote the ability of investors to understand the key attributes of order types offered by their brokers so that they can make an informed choice as to whether to

¹⁷ 15 U.S.C. 78o-3(b)(6).

use a particular type of order. This is especially true with more complex order types, such as stop loss orders, and particularly if FINRA rules permit a variety of stop loss orders to be offered.

Because of this potential investor confusion, and resulting investor harm, that could result from FINRA's proposed rule change, the Commission is concerned the proposal is not designed, among other things, to protect investors and the public interest, and promote just and equitable principles of trade, as required by Section 15A(b)(6) of the Exchange Act. The proposed rule change filed by FINRA, and its subsequent response to comments, does not adequately address these concerns. FINRA's proposal simply states that "FINRA believes that adopting the proposed rule change will provide members with the flexibility to determine whether the execution of stop orders will be triggered by transactions or quotations in the subject security without compromising investor protection."¹⁸ Neither the proposed rule change, nor FINRA's subsequent response to comments, offers any substantive explanation as to why providing flexibility in the types of stop orders offered by members – particularly without a clearly enforceable disclosure requirement – is consistent with the provisions of Section 15A(b)(6) referenced above. The Commission notes that Rule 700(b)(3) of its Rules of Practice reiterates that "[t]he burden to demonstrate that a proposed rule change is consistent with the Exchange Act ... is on the self-regulatory organization that proposed the rule change" and that a "mere assertion that the proposed rule change is consistent with those requirements ... is not

¹⁸ See Notice, supra note 3.

sufficient.”¹⁹ For the reasons articulated above, the Commission does not believe that FINRA has met that burden in this case.

IV. Conclusion

For the foregoing reasons, the Commission does not find that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities association, and, in particular, with Section 15A(b)(6) of the Act.

IT IS THEREFORE ORDERED, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR-FINRA-2010-055) be, and hereby is, disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁰

Cathy H. Ahn
Deputy Secretary

¹⁹ 17 CFR 201.700(b)(3).

²⁰ 17 CFR 200.30-3(a)(12).