

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-65579; File No. SR-FINRA-2011-052)

October 17, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material (“IM”) 2320 as FINRA Rule 5310 in the Consolidated Rulebook

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> notice is hereby given that on October 4, 2011, 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 Rule 2320 (Best Execution and Interpositioning) and Interpretive Material (“IM”) 2320 (Interpretive Guidance with Respect to Best Execution Requirements) as a FINRA rule in the consolidated FINRA rulebook with four notable changes. The proposed rule change would combine and renumber NASD Rule 2320 and IM-2320 as FINRA Rule 5310 in the consolidated FINRA rulebook.

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

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

<sup>2</sup> 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”),<sup>3</sup> FINRA is proposing to adopt NASD Rule 2320 (Best Execution and Interpositioning) and IM-2320 (Interpretive Guidance with Respect to Best Execution Requirements) as a FINRA rule in the Consolidated FINRA Rulebook with several changes, which are described below.

NASD Rule 2320 requires a member, in any transaction for or with a customer or a customer of another broker-dealer, to use “reasonable diligence” to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule identifies five factors that are

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<sup>3</sup> 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).

among those to be considered in determining whether the member has used reasonable diligence: (1) the character of the market for the security; (2) the size and type of transaction; (3) the number of markets checked; (4) the accessibility of the quotation; and (5) the terms and conditions of the order as communicated to the member. The rule also includes provisions related to interpositioning (i.e., interjecting a third party between the member and the best available market), the use of a broker's broker,<sup>4</sup> the staffing of order rooms, and the application of the best execution requirements to other parties.

In addition to these provisions, NASD Rule 2320(f) (commonly referred to as the "Three Quote Rule") generally requires members that execute transactions in non-exchange-listed securities on behalf of customers to contact a minimum of three dealers (or all dealers if three or fewer) and obtain quotations from those dealers if there are fewer than two quotations displayed on an inter-dealer quotation system that permits quotation updates on a real-time basis. The Three Quote Rule was adopted in 1988 to further define a firm's best execution obligation to customers by setting forth additional requirements for transactions in non-exchange-listed securities, particularly transactions involving securities with non-transparent prices.<sup>5</sup> Since that time, the Three Quote Rule has been amended on multiple occasions to exclude certain securities and transactions.<sup>6</sup> The Three Quote Rule establishes a minimum standard, and compliance with

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<sup>4</sup> The proposed rule change moves part of the provision concerning the use of a broker's broker from paragraph (b) of the rule to Supplementary Material .05.

<sup>5</sup> See Securities Exchange Act Release No. 25637 (May 2, 1988), 53 FR 16488 (May 9, 1988).

<sup>6</sup> See NASD Rule 2320(f)(3)(B), (C). See also Securities Exchange Act Release No. 56004 (July 2, 2007), 72 FR 37285 (July 9, 2007); Securities Exchange Act Release No. 43319 (September 21, 2000), 65 FR 58589 (September 29, 2000).

the Three Quote Rule, in and of itself, does not mean that a member has met its best execution obligations under NASD Rule 2320.<sup>7</sup>

IM-2320 was adopted in 2006 to codify interpretive guidance that FINRA staff had provided involving compliance with NASD Rule 2320.<sup>8</sup> Specifically, IM-2320 addresses issues involving the term “market” for purposes of the rule as well as the application of the rule to debt securities and to broker-dealers that are executing a customer’s order against the broker-dealer’s quote.

FINRA is proposing to adopt new FINRA Rule 5310, which is based largely on NASD Rule 2320. IM-2320 will be adopted, in substantially the same form, as Supplementary Material to Rule 5310. FINRA is also proposing several changes, which are described below, to the rule.

#### (1) The Three Quote Rule

Since the adoption of the Three Quote Rule over twenty years ago, the market for non-exchange-listed securities has changed dramatically.<sup>9</sup> FINRA has found that in certain circumstances the Three Quote Rule can hinder, rather than further, investor protection by causing significant delays in obtaining execution of customer orders. As a result, FINRA has created several exclusions to the Three Quote Rule since it was adopted. For example, in 2000, FINRA determined that where there were two transparent, firm quotes for a security, the costs associated with delayed executions resulting from Three Quote Rule

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<sup>7</sup> See NASD Notice to Members 00-78 (November 2000).

<sup>8</sup> See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006).

<sup>9</sup> For purposes of the Three Quote Rule, a “non-exchange-listed security” is any equity security that is not traded on any national securities exchange, but does not include restricted securities. See NASD Rule 2320(f)(4)(C).

compliance outweighed the benefits of obtaining three telephone quotes.<sup>10</sup> Consequently, the Three Quote Rule currently applies only to non-exchange-listed securities with one or no public quotation.<sup>11</sup> More recently, in 2007, the SEC approved amendments to the Three Quote Rule to exclude certain transactions in non-exchange-listed securities of foreign issuers that are part of the FTSE All-World Index and to exclude certain transactions in Canadian securities executed on a Canadian exchange.<sup>12</sup>

Although the original concerns the Three Quote Rule was designed to address are still valid, FINRA believes that the current requirements in the Three Quote Rule, even with the various exclusions, are overly prescriptive and can often result in unnecessary delay in the execution of a customer's order or impose requirements that do not benefit the customer. Accordingly, rather than maintain the Three Quote Rule and the various exclusions in their current format, the proposed rule change replaces the Three Quote Rule with Supplementary Material emphasizing a member's best execution obligations when handling an order involving any security, equity or debt, for which there is limited pricing information available.<sup>13</sup> The

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<sup>10</sup> See NASD Notice to Members 00-78 (November 2000); see also Securities Exchange Act Release No. 43319 (September 21, 2000), 65 FR 58589 (September 29, 2000).

<sup>11</sup> See NASD Rule 2320(f)(3)(A).

<sup>12</sup> Securities Exchange Act Release No. 56004 (July 2, 2007), 72 FR 37285 (July 9, 2007). See Regulatory Notice 07-40 (August 2007).

<sup>13</sup> NASD Rule 2320(f)(2), which is a subparagraph within the Three Quote Rule, generally requires members that display priced quotations on a real-time basis for a non-exchange-listed security in two or more quotation mediums that permit quotation updates on a real-time basis to display the same priced quotation in each medium except for certain customer limit orders displayed on an electronic communications network. Paragraph (f)(4) of the rule includes definitions of terms used in paragraph (f)(2). At this time, FINRA is proposing to move paragraph (f)(2) into the FINRA Rule 6400 Series (Quoting and Trading in OTC Equity Securities) as FINRA Rule 6438. FINRA is also proposing to replace the term "non-exchange-listed security" with the term "OTC Equity Security" to conform the rule language to other FINRA rules addressing non-NMS stocks. The terms "OTC Equity Security" and "quotation medium" are defined in FINRA Rule 6420.

Supplementary Material emphasizes that members must be especially diligent with respect to best execution obligations where there is limited quotation or other pricing information available regarding the security that is the subject of the order and requires members to have written policies and procedures in place to address the steps the member will take to determine the best market for such a security in the absence of multiple quotations or pricing information and to document how they have complied with those policies and procedures.<sup>14</sup> The Supplementary Material specifically notes that, when handling orders for such securities, members should generally seek out other sources of pricing information or potential liquidity, which may include obtaining quotations from other sources (e.g., other firms that the member previously has traded with in the security). For example, in many instances, particularly in the context of equity securities with limited quotation information available, contacting other broker-dealers may be necessary to comply with a member's best execution obligations.<sup>15</sup>

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Because the provisions relate to the quotation of OTC Equity Securities, FINRA believes that they should be relocated into the FINRA rule series concerning quoting and trading OTC Equity Securities rather than remain part of the Best Execution Rule.

<sup>14</sup> NASD Rule 3110(b) (Books and Records) generally requires members to indicate on the customer order ticket how they complied with the Three Quote Rule, if applicable. FINRA is proposing to replace this provision with a more general documentation requirement in the Supplementary Material to proposed FINRA Rule 5310. Under that provision, members would be required to retain records sufficient to demonstrate that they had handled orders covered by the rule in accordance with their policies and procedures.

<sup>15</sup> As noted above, FINRA believes that requiring compliance with the Three Quote Rule in all circumstances covered by the rule can cause unnecessary delay in the handling of some customer orders. However, as the Supplementary Material recognizes, contacting other broker-dealers can often be necessary for a firm to meet its best execution obligations. In recognizing the importance of contacting other broker-dealers for pricing or liquidity information, FINRA notes that many firms may choose to adopt policies and procedures that are substantially similar to the current Three Quote Rule but may, for example, allow for firms to adapt their procedures for certain situations if the firm reasonably concludes that those requirements would result in unnecessary delay or otherwise not benefit the customer. Firms must also continue to take into account when developing their procedures that the Three Quote Rule is a minimum standard, and

## (2) Regular and Rigorous Review of Execution Quality

The proposed rule change includes Supplementary Material to proposed FINRA Rule 5310 codifying a member's obligations when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers. These longstanding obligations are set forth and explained in various SEC releases and NASD Notices to Members.<sup>16</sup> The proposed rule change codifies this guidance as Supplementary Material and does not alter existing requirements regarding regular and rigorous review.

## (3) Orders for Foreign Securities with No U.S. Market

While the determination as to whether a member has satisfied its best execution obligations must take into account the market for a security, NASD Rule 2320 does not specifically distinguish between orders for domestic securities and orders for foreign securities, even if there is no U.S. market for the security. Markets in foreign jurisdictions often do not have identical best execution requirements as those imposed by NASD Rule 2320 and, in many cases, may not have comparable pre-trade or post-trade transparency standards. Thus, the handling of orders for foreign securities with no U.S. market can differ substantially from the handling of orders in securities that trade in the U.S. Consequently, the proposed rule change includes new Supplementary Material concerning members' best execution obligations when handling orders for foreign securities, and in particular foreign securities with no U.S. trading activity.<sup>17</sup>

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contacting other dealers does not guarantee that a firm has met its best execution obligations in all cases.

<sup>16</sup> See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); NASD Notice to Members 01-22 (April 2001).

<sup>17</sup> As discussed more fully in Section 2(C)(2) below, in Regulatory Notice 08-80 FINRA had proposed a different approach regarding orders for foreign securities with no U.S. market.

The new Supplementary Material recognizes that markets for different securities can vary dramatically and that the standard of “reasonable diligence” must be assessed by examining specific factors, including “the character of the market for the security” and the “accessibility of the quotation.” Accordingly, the determination as to whether a member has satisfied its best execution obligations necessarily involves a “facts and circumstances” analysis.

The new Supplementary Material notes that even though a foreign security may not trade in the U.S., members still have an obligation to seek best execution for customer orders involving the security. Consequently, a member that handles customer orders for foreign securities that do not trade in the U.S. must have specific written policies and procedures in place regarding its handling of customer orders for these securities that are reasonably designed to obtain the most favorable terms available for the customer, taking into account differences that may exist between U.S. markets and foreign markets. The Supplementary Material further notes that a member’s best execution obligations also must evolve as changes occur in the market that may give rise to improved executions, including opportunities to trade at more advantageous prices. Members must therefore regularly review their policies and procedures to assess the quality of executions received and update or revise the policies and procedures as necessary.

#### (4) Customer Instructions Regarding the Routing of Orders

When placing an order with a member, customers may specifically instruct the member to route the order to a particular market for execution.<sup>18</sup> The proposed rule change includes Supplementary Material to proposed FINRA Rule 5310 addressing situations where the customer has, on an unsolicited basis, specifically instructed the member to route its order to a particular

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<sup>18</sup> When the order is for an NMS security, these orders are often referred to as “directed orders.” See 17 CFR 242.600(b)(19). Of note, directed orders are excluded from the order routing statistics required to be produced under Rule 606 of SEC Regulation NMS. See 17 CFR 242.606.



market.<sup>19</sup> Under those circumstances, the member would not be required to make a best execution determination beyond that specific instruction; however, the Supplementary Material mandates that members process the customer's order promptly and in accordance with the terms of the order. The Supplementary Material also makes clear that where a customer has directed the member to route an order to another broker-dealer that is also a FINRA member, the exception would not apply to the receiving broker-dealer to which the order was directed.<sup>20</sup>

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. The implementation date will be no later than 90 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,<sup>21</sup> 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 the proposed rule change adds needed clarification and provisions to the existing best execution requirements that enhance investor protection and promote just and equitable principles of trade. FINRA believes that codifying members' obligations regarding directed orders, regular and rigorous review, and orders involving foreign securities will bring needed

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<sup>19</sup> FINRA also has proposed technical amendments to paragraph (e) of the rule to clarify that a member's best execution obligations extend to all customer orders and to avoid the potential misimpression that the paragraph limits the scope of the rule's requirements.

<sup>20</sup> For example, if a customer of Member Firm A directs Member Firm A to route an order to Member Firm B, Member Firm B would continue to have best execution obligations to that customer order received from Member Firm A.

<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

clarification to these areas and ensure that all members are aware of their obligations. As discussed above, FINRA believes that replacing the Three Quote Rule with the proposed Supplementary Material will improve the handling of customer orders involving securities with limited quotation or pricing information by decreasing the likelihood that execution of these orders will be unnecessarily delayed while still ensuring that members recognize that their best execution obligations apply to these orders. FINRA believes that each of these provisions will help promote just and equitable principles of trade and will protect investors and the public interest.

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 08-80 (December 2008). A copy of Regulatory Notice 08-80 is attached as Exhibit 2a. The comment period expired on February 27, 2009. FINRA received nine comment letters in response to the Regulatory Notice.<sup>22</sup> A list of the comment letters received in response to Regulatory Notice 08-80 is attached as Exhibit 2b. Copies of the comment letters received in response to Regulatory Notice 08-80 are attached as Exhibit 2c.

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<sup>22</sup> Letter from first allied ("First Allied"), dated January 27, 2009; Letter from Sidley Austin LLP ("Sidley"), dated January 28, 2009; Letter from Scottrade, Inc. ("Scottrade"), dated January 29, 2009; Letter from National Association of Independent Broker-Dealers, Inc. ("NAIBD"), dated February 16, 2009; Letter from Cutter & Company, Inc. ("Cutter"), dated February 17, 2009; Letter from Securities Industry and Financial Markets Association ("SIFMA"), dated February 26, 2009; Letter from Financial Services Institute ("FSI"), dated February 27, 2009; Letter from Pink OTC Markets, Inc. ("Pink OTC"), dated March 20, 2009; Letter from Liquidnet, Inc. ("Liquidnet"), dated April 24, 2009.

(1) General Comments on the Proposed Rule Change

Although most commenters addressed particular issues in the rule changes proposed in Regulatory Notice 08-80, some commenters raised broader concerns regarding best execution obligations and NASD Rule 2320 in general. SIFMA expressed concerns about the application of the Best Execution Rule to debt securities and reiterated the concerns previously expressed by the Bond Market Association in response to prior amendments to NASD Rule 2320.<sup>23</sup> In essence, SIFMA asserts that fundamental differences in the operation of the equity and fixed income markets render the Best Execution Rule inappropriate for the fixed income market. SIFMA states that the current Best Execution Rule, as well as many of the amendments in the proposed rule change, may be appropriate for the equity markets but “create problems of interpretation, application and enforcement” in the context of the fixed income markets.

FINRA disagrees. As SIFMA’s letter notes, these concerns have been raised numerous times in recent years, and for the same reasons FINRA has noted before, FINRA believes that the Best Execution Rule is broad enough to apply to both the equity and fixed income markets. As FINRA stated in 2005:

[The] Best Execution Rule looks at a number of factors, including the character of the market for the security, to determine whether a member or associated person(s) has used reasonable diligence. Accordingly, it can be applied in a variety of different markets that can possess divergent characteristics, including the U.S. debt market.<sup>24</sup>

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<sup>23</sup> See SIFMA.

<sup>24</sup> See Securities Exchange Act Release No. 52637 n.15 (October 19, 2005), 70 FR 61861, 61863 n.15 (October 26, 2005).

The Best Execution Rule requires the use of “reasonable diligence” when handling a customer order. One of the enumerated factors in assessing whether reasonable diligence has been used is “the character of the market for the security.”<sup>25</sup> This language makes readily apparent that a determination of best execution must take into account the specific facts and circumstances surrounding the market in which a security trades, whether that is an exchange market, the over-the-counter equity market, or the fixed income market. Different securities trade in myriad ways, and no single rule can address each and every nuance of various types of markets. Moreover, market structure is itself subject to continuous evolution and development; a rule focused on a specific market structure would quickly become outdated. For all of these reasons, the Best Execution Rule is intentionally broad and encompasses all market types by its recognition that a best execution determination cannot be made without first determining the type of market in which the security that is the subject of the order trades.

One commenter suggested that proposed Supplementary Material .01 regarding prompt execution of a marketable customer order<sup>26</sup> be clarified to note that a firm’s acceptance of an order “starts the clock” as opposed to the time a customer enters an order or the time an order is received.<sup>27</sup> The Supplementary Material requires “prompt” execution and does not dictate a specific timeframe because FINRA believes the principle-based standard of acting promptly would encompass all reasonable factors that a prescriptive standard could not address in all cases. Best execution requires firms to minimize the time between order receipt, order

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<sup>25</sup> See NASD Rule 2320(a)(1)(A).

<sup>26</sup> In Regulatory Notice 08-80, FINRA proposed to apply the prompt requirement in Supplementary Material .01 to customer market orders. The proposed rule change applies the prompt requirement in proposed Supplementary Material .01 to “marketable customer orders” to clarify that the requirement applies to both market orders and marketable limit orders.

<sup>27</sup> See Scottrade.

acceptance, and order entry. Firms may not defend their failure to act promptly in respect of an order because such an order languished between its receipt and entry. In addition, FINRA has already codified the obligation to handle and execute marketable customer orders promptly in FINRA Rule 5320.07.

(2) Comments Regarding Orders for Foreign Securities with No U.S. Market

In Regulatory Notice 08-80, FINRA proposed to adopt a new provision regarding a member's best execution obligations for foreign securities with no U.S. market. Under that provision, a member would have been deemed to have exercised reasonable diligence pursuant to Rule 5310(a) with respect to an order if:

- (i) the order was for a non-U.S. traded security;<sup>28</sup>
- (ii) the member had adopted written policies and procedures regarding its handling of orders for non-U.S. traded securities that are reasonably designed to obtain the most favorable terms available for the customer;
- (iii) the member reviewed those policies and procedures at least annually, or more frequently as appropriate, to assess the quality of the execution venues included in the member's policies and procedures to determine whether they provide for the most favorable terms reasonably available and whether the policies and procedures needed to be updated or revised;
- (iv) the member had obtained its customers' consent to its policies and procedures regarding the handling of orders for non-U.S. traded securities; and

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<sup>28</sup> For purposes of the provision, FINRA proposed to define a "non-U.S. traded security" as any non-exchange-listed security issued by a corporation or other entity incorporated or organized under the laws of any foreign country for which there is no quotation or indication of interest displayed in any inter-dealer quotation system generally available in the United States at the time the member receives the order.

(v) the member handled the order in accordance with its policies and procedures.

The proposed provision did not except these orders from the reasonable diligence requirement; rather, in recognition of the differences in how such orders are handled, it provided an alternative mechanism, other than the current list of factors in the rule, in determining whether a firm had met the reasonable diligence obligation.

Although several commenters generally supported the proposed provision addressing foreign securities with no U.S. market, commenters raised numerous issues with specific aspects of the provision. Multiple commenters questioned the requirement that a customer consent to the member's policies and procedures.<sup>29</sup> In addition, commenters also requested guidance on several of the provision's terms and requirements, including asking for additional guidance of "a non-exclusive list of elements for what a typical set of execution protocols might cover,"<sup>30</sup> clarification that the presence of American Depositary Receipts with an active market in the U.S. would not affect the analysis with respect to the issuer's ordinary shares,<sup>31</sup> and questioning portions of the definition of non-U.S. traded security.<sup>32</sup>

FINRA continues to believe it is appropriate to address specifically as part of the Best Execution Rule issues involving members' best execution obligations when handling orders for foreign securities with no U.S. market; however, as noted above, FINRA has replaced the proposed provision with Supplementary Material that more generally describes the obligations members have regarding these orders.

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<sup>29</sup> See First Allied, Scottrade, SIFMA.

<sup>30</sup> SIFMA.

<sup>31</sup> See Sidley.

<sup>32</sup> See Sidley, Pink OTC.

(3) Comments on Proposed Supplementary Material .06 (Orders Involving Securities with Limited Quotations or Pricing Information)

Six commenters addressed the proposal to replace the Three Quote Rule with more general Supplementary Material regarding a member's obligations when handling an order for a security for which there is limited pricing information available. Of the six commenters, five supported the proposal,<sup>33</sup> and one commenter opposed the proposed change because the commenter believed that the current Three Quote Rule promotes "straightforward best execution compliance."<sup>34</sup> As FINRA has stressed in the past, the Three Quote Rule is a minimum standard that members are required to meet with respect to non-exchange-listed securities with one or no public quotation; compliance with the Three Quote Rule does not, in and of itself, mean that a member has met its best execution obligations.<sup>35</sup> Thus, contrary to the commenter's assertion that the Three Quote Rule established a straight-forward compliance standard, it sets forth only a non-exhaustive minimum standard.

As noted above, best execution requires the exercise of reasonable diligence. If a security has little or no price transparency, FINRA agrees that a member with an order for such a security should generally seek out other sources of pricing information or potential liquidity, which could include contacting other dealers. Consequently, the Supplementary Material specifically notes that members "should generally seek out other sources of pricing information or potential liquidity, which may include obtaining quotations from other sources . . . ." However, FINRA believes that there continue to be instances where contacting additional dealers may not be in the

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<sup>33</sup> See Cutter, First Allied, Liquidnet, NAIBD, SIFMA.

<sup>34</sup> Pink OTC.

<sup>35</sup> See, e.g., NASD Notice to Members 00-84 (December 2000).

customer's best interest (and, indeed, may be detrimental to the customer).<sup>36</sup> Although the proposed Supplementary Material gives members the ability to determine when that is the case, members continue to have best execution obligations in handling the order.

The commenter also requested that FINRA "state, whether in the text of the Rule or the Supplementary Material, that member firms must execute customer orders at an equal or better price as displayed in any Inter-Dealer Quotation System that permits quotation updates on a real-time basis."<sup>37</sup> FINRA does not believe it is necessary to specifically address this point with respect to the types of orders currently covered under the Three Quote Rule. As is already the case today, paragraph (a)(1) of the proposed rule requires that members use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that "the resultant price to the customer is as favorable as possible under prevailing market conditions." That standard has always applied to orders covered by the Three Quote Rule (indeed, it applies to all customer orders) and will continue to apply under the proposed rule.

As noted above, as part of replacing the Three Quote Rule with Supplementary Material, FINRA has proposed replacing the specific recordkeeping requirements in NASD Rule 3110(b) with a more general recordkeeping requirement. One commenter requested additional guidance on the documentation requirement;<sup>38</sup> however, FINRA is unable to provide specific guidance to a recordkeeping requirement that will vary with the adaptive practices of firms in meeting the principle-based requirements of the rule. Each member must retain sufficient documentation to demonstrate that it has complied with the policies and procedures that it has in place. Because

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<sup>36</sup> For example, one commenter asserted that contacting multiple dealers regarding an order in a fixed income security could have the effect of moving the market away from the customer in some circumstances. See SIFMA.

<sup>37</sup> Pink OTC.

<sup>38</sup> See SIFMA.



there will no longer be uniform treatment of these types of orders and different firms will have different procedures under the proposal, there can be no uniform recordkeeping requirement.

(4) Comments on Proposed Supplementary Material .09 (Regular and Rigorous Review of Execution Quality)

Five commenters addressed proposed Supplementary Material .09, which codifies the obligations of some firms to regularly and rigorously review execution quality.<sup>39</sup> One commenter questioned the rationale of codifying these obligations, which are already “well understood” by the industry and asserted that codification would take them away from being “fluid and evolving” standards and make them more rigid and difficult to change.<sup>40</sup> FINRA disagrees. As noted above, the proposed Supplementary Material does not alter existing obligations or standards, and the language of the proposed provision is sufficiently flexible to allow the obligations to evolve along with the markets. Although the commenter expressed concern about the ability to change or amend the provision once it is codified within a FINRA rule, the general obligations of regular and rigorous review have not changed substantially since FINRA issued Notice to Members 01-22 in 2001. Moreover, FINRA retains the ability to continue to publish interpretive guidance on the requirements or amend the requirements through rulemaking even if their general contours are codified.

Two commenters suggested that the requirement to periodically review the execution quality of orders not apply to introducing firms with respect to those orders placed through their clearing firm.<sup>41</sup> One commenter stated that, because of the lack of expertise among introducing firms, the requirement leads to a “pro forma review process” that does not meaningfully enhance

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<sup>39</sup> Cutter, First Allied, NAIBD, Pink OTC, SIFMA.

<sup>40</sup> SIFMA.

<sup>41</sup> See Cutter, FSI.

investor protection.<sup>42</sup> These commenters seem to suggest that, because the clearing firm itself has a best execution obligation with respect to the order, the introducing firm should be relieved of its best execution obligation. FINRA does not find these comments persuasive and has consistently rejected this rationale. Every member has an obligation to ensure that each customer order it handles receives best execution, and regular and rigorous review is one method by which firms that route orders to other members (or execute orders internally) can meet their best execution obligations. That is, regular and rigorous reviews are one way for order entry firms and firms that internalize order flow to satisfy their best execution obligations in lieu of an order-by-order best execution analysis.

Three commenters requested that FINRA provide more specific guidance about the types of information introducing firms should review (and clearing firms should provide) and the frequency of the reviews so that introducing firms can ensure they meet their obligations if they choose to rely on their clearing firm.<sup>43</sup> One of these commenters asked FINRA to confirm whether a review of “those reports prepared and disclosed by executing firms in meeting their obligations under order routing regulations will suffice for the purposes of this review.”<sup>44</sup> FINRA has previously provided guidance on these questions, and the guidance will continue to be applicable. For example, in Notice to Members 01-22, FINRA stated:

In cases where the introducing broker/dealer is relying on the review conducted by its clearing firm or other executing broker/dealer, the introducing firm must ensure that such analysis is thorough, considers the execution quality of a broad range of

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<sup>42</sup> FSI.

<sup>43</sup> See FSI, NAIBD, SIFMA.

<sup>44</sup> NAIBD.

market centers, measures the execution quality provided by the clearing or executing firm for the introducing firm's own orders, and considers market centers to which the clearing or executing firm currently routes its order flow as well as market centers other than those to which the clearing or executing firm currently routes its order flow.

As is the case currently, an introducing firm must review information sufficient to conclude that its clearing firm is providing best execution and is conducting a thorough regular and rigorous review. While in some instances a review of required regulatory reports may suffice, in other instances such a review may not. For example, if a review of required regulatory order routing reports raised concerns or issues, then FINRA would expect the introducing firm to conduct a further inquiry and review. This is currently the case under existing FINRA rules and would remain the case under the proposed rule change. As FINRA stated in Regulatory Notice 08-80, in codifying regular and rigorous review standards, FINRA did not intend to alter existing requirements or obligations.

One commenter asked FINRA to state that regular and rigorous review is only required with respect to “retail-sized, held orders in equity securities for which execution quality statistics are required to be published by market centers pursuant to Rule 605 of Regulation NMS.”<sup>45</sup> The commenter further stated that regular and rigorous reviews are not appropriate for not held orders and that “the assessment of execution quality for not held orders is effectively done on an individual, order-by-order basis, in real-time and/or on a post-trade basis.” FINRA does not view regular and rigorous review as ever being “required.” Rather, regular and rigorous review

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<sup>45</sup> SIFMA.

permits order entry firms and firms that internalize order flow to meet their best execution obligations through the use of a periodic regular and rigorous review of execution quality; this review stands in the place of an order-by-order review. Therefore, conducting an order-by-order, individual review for not held orders would eliminate the need for a regular and rigorous review of those order types.

One commenter stated that “efficiency of execution” should be added as a factor for members to consider when conducting their regular and rigorous review.<sup>46</sup> FINRA views “efficiency of execution,” not as a separate factor, but rather as a term that would encompass several of the existing listed factors (e.g., speed and size of execution). Moreover, the list in the Supplementary Material is intended to be illustrative, not exhaustive.

This commenter also suggests that the factors of speed, size, and transaction costs should be qualified by a materiality standard. These factors are already qualified by a materiality standard under proposed Supplementary Material .09(b), which requires that, “[i]n conducting its regular and rigorous review, a member must determine whether any material differences in execution quality exist among the markets trading the security . . . .” The Supplementary Material then goes on to identify a number of factors a member should consider when reviewing and comparing execution quality. However, as proposed in Regulatory Notice 08-80, the first two factors identified included an additional reference to “materiality.” To avoid confusion, FINRA has removed the additional reference to materiality in the first two factors to avoid the misimpression that the other factors do not have a materiality standard.

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<sup>46</sup> Scottrade.

(5) Comments on Proposed Supplementary Material .08 (Customer Instructions Regarding Order Handling)

Proposed Supplementary Material .08 addresses a member's obligations when a customer directs, on an unsolicited basis, the member to execute the order in a specific market. Only one commenter opposed the proposed Supplementary Material, stating that "it is the firm's responsibility to always make a best execution determination in all cases whether specifically instructed to route its order to a particular market or not."<sup>47</sup> FINRA agrees that members have best execution responsibilities with respect to each and every customer order the member accepts; however, when a customer directs a member to execute an order in a specific market, the construct of paragraph (a)(1) of the rule is no longer applicable. As noted above, paragraph (a)(1) of the rule requires a member to use reasonable diligence to ascertain the best market for the subject security. When a customer specifies the market, that is no longer a determination that the member can make. However, the Supplementary Material makes clear that members are still required to handle the order promptly and in accordance with its terms.

One commenter suggested that the "unsolicited" requirement not apply to orders involving foreign securities.<sup>48</sup> The commenter suggested that a customer should not be deprived of the firm's advice in this area. The rule was not intended to, and does not, deprive a customer of a firm's advice regarding routing decisions; rather, it simply recognizes that in those cases where a customer has made its own routing decision, the member cannot choose a different market for execution without violating the terms of the order. If a member, by contrast, undertakes to advise the customer on routing venues, it should be bound by general best execution obligations with respect to the execution of that order. In addition, however, the

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<sup>47</sup> First Allied.

<sup>48</sup> See Sidley.

commenter stated that a firm and a customer “may on the basis of long usage and course of dealing have concluded that the customer’s orders for foreign securities are most effectively executed in the principal market for such securities in the issuer’s home country.” In the alternative, the commenter suggested that the exception could be available when a customer has instructed that an order for a foreign security be executed in the security’s principal market. FINRA agrees with the commenter to the extent that a customer need not provide the direction on an order-by-order basis. Thus, for example, the rule would apply if a customer has made a more general instruction with respect to particular types of orders or securities.

One commenter, while supporting the proposal, suggested that it be broadened to include orders where the broker’s judgment and discretion are considerably restricted because of other order terms and conditions.<sup>49</sup> FINRA does not agree that the exception should be so broadened. Paragraph (a)(1)(E) of the proposed rule already notes that one of the factors in any analysis of best execution is the terms and conditions of the order. FINRA believes that the exception should only apply in those circumstances where the ultimate decision that must be made with respect to the order (i.e., execution venue) is specifically directed by the customer. All other terms and conditions are adequately addressed in the rule itself.

#### (6) Comments on Proposed FINRA Rule 6438

FINRA received several comments regarding the proposal to move the same quote requirements in NASD Rule 2320(f)(2) into a separate rule.<sup>50</sup> One commenter suggested that FINRA amend the provision to require “similar,” rather than the “same,” quotes and questioned the application of the provision if a member has multiple trading desks that quote the same

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<sup>49</sup> See SIFMA.

<sup>50</sup> See Pink OTC, SIFMA.

security.<sup>51</sup> Another commenter<sup>52</sup> suggested that FINRA not alter the definitions of the terms “quotation medium” and “inter-dealer quotation system” from the way these terms are laid out in Exchange Act Rule 15c2-11(e).<sup>53</sup> This commenter also suggested that the same quote requirements apply to inter-dealer quotation systems rather than quotation mediums. As noted above, at this time, FINRA is proposing to transfer the provisions into a separate rule without change; FINRA believes that the objectives behind adopting this requirement are still valid and is not proposing to amend this provision at this time. In addition, by relocating the provision into the FINRA Rule 6400 Series, the defined terms at issue are already defined in existing FINRA Rule 6420.

#### (7) Other Comments

Some commenters provided comments on portions of the rule that FINRA has not proposed to change. For example, one commenter requested that the language in proposed Rule 5310(d) be updated to refer to defined industry terms (e.g., “clearing firm”) rather than descriptions (e.g., “third party pursuant to established correspondent relationships under which executions are confirmed directly to the member acting as agent for the customer”).<sup>54</sup> Although the term “clearing firm” is generally understood, it is not defined in any FINRA rule; consequently, FINRA determined to retain the existing descriptions to avoid any unintended changes in the scope of the rule or any misunderstandings regarding the use of the term. In light of this comment, however, FINRA has replaced the references to “introducing firms” and

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<sup>51</sup> SIFMA.

<sup>52</sup> Pink OTC.

<sup>53</sup> 17 CFR 240.15c2-11(e).

<sup>54</sup> FSI.

“clearing firms” in Supplementary Material .09(c) in addition to clarifying the scope of that provision as proposed in Regulatory Notice 08-80.<sup>55</sup>

Finally, one commenter asked FINRA to clarify the meaning of proposed FINRA Rule 5310(c) (current NASD Rule 2320(c)) regarding costs borne by a customer.<sup>56</sup> That provision states that “the channeling of customers’ orders through a broker’s broker or third party pursuant to established correspondent relationships under which executions are confirmed directly to the member acting as agent for the customer . . . are not prohibited if the cost of such service is not borne by the customer.” The commenter asked whether the provision applied to all costs or, rather, to additional or undue costs. In light of this comment, and the fact that the SEC has approved revisions to the interpositioning provisions in the Best Execution Rule that address sending orders through third parties,<sup>57</sup> FINRA is proposing to delete the sentence from the Best Execution Rule. FINRA believes that the issues the provision covers are adequately addressed in the revised interpositioning provision.

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

Within 45 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 FINRA consents, the Commission shall: (a) by order approve or disapprove such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>55</sup> See SIFMA.

<sup>56</sup> NAIBD.

<sup>57</sup> See Securities Exchange Act Release No. 60635 (September 8, 2009), 74 FR 47302 (September 15, 2009).



#### 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](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2011-052 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-2011-052. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such 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 publicly available. All submissions should refer to File Number SR-FINRA-2011-052 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.<sup>58</sup>

Elizabeth M. Murphy  
Secretary

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<sup>58</sup> 17 CFR 200.30-3(a)(12).