

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-67774; File No. SR-FINRA-2012-025)

September 4, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as modified by Amendment No. 1, to Adopt Existing NASD IM-2110-3 as New FINRA Rule 5270 (Front Running of Block Transactions) with Changes in the Consolidated FINRA Rulebook

I. Introduction

On May 17, 2012, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) 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 adopt existing NASD Interpretive Material (“IM”) 2110-3 (Front Running Policy) as proposed FINRA Rule 5270 to amend the existing Front Running Policy in several ways to broaden its scope and provide further clarity into activities that FINRA believes are inconsistent with just and equitable principles of trade. The proposed rule change was published for comment in the Federal Register on June 6, 2012.<sup>3</sup> The Commission received two comment letters on the proposed rule change,<sup>4</sup> and a response to comments from FINRA.<sup>5</sup> On August 30, 2012, FINRA submitted

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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. 67079 (May 30, 2012), 77 FR 33522 (“Notice”).

<sup>4</sup> See Letters to Elizabeth M. Murphy, Secretary, Commission, from Ryan K. Bakhtiari, President, Public Investors Arbitration Bar Association (“PIABA”), dated June 26, 2012 (“PIABA Letter”); and Sean Davy, Managing Director, Corporate Credit Markets Division, Securities Industry and Financial Markets Association (“SIFMA”), dated July 9, 2012 (“SIFMA Letter”).

<sup>5</sup> See Letter from Brant K. Brown, Associate General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated August 29, 2012 (“FINRA Response”).

Amendment No. 1 to the proposal.<sup>6</sup> This order approves the proposed rule change, as modified by Amendment No. 1.

## II. Description of the Proposal

As part of the process of developing a consolidated rulebook,<sup>7</sup> FINRA proposed to adopt existing NASD IM-2110-3 (“Front Running Policy”) as proposed FINRA Rule 5270 with the changes described below.

### A. Current Front Running Policy

The current Front Running Policy states that it shall be considered conduct inconsistent with just and equitable principles of trade for a member or a person associated with a member, for an account in which such member or person associated with a member has an interest or exercises investment discretion or for certain customer accounts, to buy or sell an option or security future when the member or person associated with a member has material, non-public market information concerning an imminent block transaction<sup>8</sup> in the underlying security or

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<sup>6</sup> In that amendment, FINRA clarified that the proposed rule would not apply to orders or transactions involving government securities. FINRA noted, however, that actions for similar front-running conduct occurring in the exempted securities markets, including the government securities market, continue to be covered by FINRA Rule 2010. In the amendment, FINRA also clarified that the 10,000 share language in proposed Supplementary Material .03 refers to equity securities. Because this amendment is technical in nature, it is not subject to notice and comment.

<sup>7</sup> The 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. See FINRA Information Notice, March 12, 2008 (Rulebook Consolidation Process).

<sup>8</sup> NASD IM-2110-3 states that “[a] transaction involving 10,000 shares or more of an underlying security, or options or security futures covering such number of shares is generally deemed to be a block transaction, although a transaction of less than 10,000 shares could be considered a block transaction in appropriate cases.”

when the customer has been provided such material, non-public market information by the member of any person associated with a member.<sup>9</sup> Similarly, the same prohibition applies for a member or any person associated with a member with respect to an order to buy or sell an underlying security when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in an option or a security future overlying that security, or when a customer has been provided such material, non-public market information by the member or any person associated with a member; prior to the time information concerning the block transaction has been made publicly available.<sup>10</sup>

The Front Running Policy also prohibits providing material, non-public market information concerning an imminent block transaction to customers who then trade on the basis of the information. The Front Running Policy is limited to transactions in equity securities and options that are required to be reported on a last sale reporting system and to any transaction involving a security future, regardless of whether the transaction is reported. The prohibitions apply until the information concerning the block transaction has been made publicly available.<sup>11</sup>

Finally, the Front Running Policy includes exceptions for “transactions executed by member participants in automatic execution systems in those instances where participants must accept automatic executions” as well as situations where a member receives a customer’s block order relating to both an option or security future and the underlying security and the member, in

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<sup>9</sup> See NASD IM-2110-3(a).

<sup>10</sup> See NASD IM-2110-3(b).

<sup>11</sup> See NASD IM-2110-3 (“when [the information] has been disseminated via the tape or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Act, an alternative trading system under Regulation ATS, or by a third-party news wire service”).

furtherance of facilitating the customer's block order, positions the other side of one or both components of the order. In the latter case, a member is still prohibited from covering any resulting proprietary position by entering an offsetting order until information concerning the block transaction has been made publicly available.

B. Proposed Changes to Front Running Policy

1. Expansion of the Front Running Policy

FINRA proposes to expand the Front Running Policy to apply to all securities and other financial instruments and contracts (in addition to the existing options and security futures) that overlay the security that is the subject of an imminent block transaction and that have a value that is materially related to, or otherwise acts as a substitute for, the underlying security.

Specifically, FINRA proposes to expand the Front Running Policy to cover trading in an option, derivative, security-based swap, or other financial instrument overlying a security that is the subject of an imminent block transaction if the value of the underlying security is materially related to, or otherwise acts as a substitute for, such security, as well as any contract that is the functional economic equivalent of a position in such security ("related financial instrument").<sup>12</sup>

The proposal would also expand the Front Running Policy when the imminent block transaction involves a related financial instrument, and prevent trading in the underlying security. The proposed rule change also would extend the Front Running Policy to include explicitly trading in the same security or related financial instrument that is the subject of an imminent block transaction.<sup>13</sup>

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<sup>12</sup> FINRA notes that the proposed rule is not intended to provide an exhaustive list of prohibited trading activity. See Notice, supra note 3.

<sup>13</sup> The trading restrictions imposed by the current Front Running Policy apply until information about the imminent customer block transaction "has been made publicly available," which the rule defines as having been disseminated to the public in trade

## 2. Amended Exceptions to the Front Running Policy

The proposed rule change would replace several existing provisions in the Front Running Policy with proposed Supplementary Material to FINRA Rule 5270. FINRA proposes to replace the existing exceptions in the Front Running Policy for certain transactions in automatic execution systems and for positioning the other side of certain orders when a member receives a customer's block order relating to both an option and the underlying security or both a security future and the underlying security. The new Supplementary Material identifies types of transactions that are permitted. Specifically, under the proposed Supplementary Material, there would be three broad categories of permitted transactions: (1) transactions that the member can demonstrate are unrelated to the customer block order; (2) transactions that are undertaken to fulfill or facilitate the execution of the customer block order; or (3) transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange. These three categories of permitted transactions are discussed below.

First, with respect to transactions that are unrelated to the customer block order, Supplementary Material .04(a) would allow members to engage in such transactions provided that the member can demonstrate that the transactions are unrelated to the material, non-public market information received in connection with the customer order. The Supplementary

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reporting data. The proposed rule change generally retains this standard for determining when information has become publicly available. However, FINRA proposes to expand the rule to include related financial instruments that may not result in publicly available trading information being made available. Accordingly, FINRA also proposes that the prohibitions in the rule be in place until the material, non-public market information is either publicly available or "has otherwise become stale or obsolete." Whether information has become stale or obsolete will depend upon the particular facts and circumstances involved, including specific information the member has regarding the transaction, but could include factors such as the amount of time that has passed since the member learned of the block transaction, subsequent trading activity in the security, or a significant change in market conditions.

Material would include a list of potentially permitted transactions as examples of transactions that, depending upon the circumstances, may be unrelated to the customer block order. These types of transactions could include transactions where the member has effective information barriers established to prevent internal disclosure of customer order information,<sup>14</sup> transactions in the security that is the subject of the customer block order that are related to a prior customer order in that security, transactions to correct bona fide errors, and transactions to offset odd-lot orders.

Second, with respect to transactions undertaken to fulfill or facilitate the execution of the customer block order, proposed Supplementary Material .04(b) would specify that Front Running Policy does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, a customer's block order.<sup>15</sup> According to FINRA, firms are permitted to trade ahead of a customer's block order when the purpose of such trading is to fulfill the customer order and when the customer has authorized such trading, including that the firm has disclosed to the customer that it may trade ahead of, or alongside of, the customer's order. FINRA proposes, however, that when engaging in trading activity that could affect the market

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<sup>14</sup> According to FINRA, in addition to more traditional information barriers, such as those in place to prevent communication between trading units, this provision could also include the use of automated systems (e.g., trades through a "black box") where the orders placed into the automated system are handled without the knowledge of a person associated with the member who may be trading in the same security. However, a person associated with a member who places an order into a "black box" or other automated system, or otherwise has knowledge of the order or the ability to access information in the system, may not then trade in the same security or a related financial instrument solely because the order ultimately was being handled by the automated system rather than by the person. Traders who have no knowledge of the order, due to the presence of an information barrier or otherwise, could continue to trade in the security or a related financial instrument. See Notice, supra note 3.

<sup>15</sup> According to FINRA, these transactions may include, for example, hedging or other positioning activity undertaken in connection with the handling of the customer order. See Notice, supra note 3.

for the security that is the subject of the customer block order, the member must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the member's financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity. The Supplementary Material would provide that a member may obtain consent through affirmative written consent or through means of a negative consent letter.<sup>16</sup> In addition, a member may provide clear and comprehensive oral disclosure to, and obtain consent from, the customer on an order-by-order basis, provided the member documents who provided the consent and such consent evidences the customer's understanding of the terms and conditions for handling the customer's order.

Finally, proposed Supplementary Material .04(c) would state that the prohibitions in the Front Running Policy shall not apply if the member's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.

### 3. Other Proposed Changes

FINRA proposes to adopt proposed Supplementary Material .05 to state that the front running of any customer order, not just imminent block transactions, that places the financial interests of the member ahead of those of its customer or the misuse of knowledge of an imminent customer order may violate other FINRA rules, including FINRA Rules 2010 and 5320, or the federal securities laws.<sup>17</sup>

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<sup>16</sup> The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders, and if the customer does not object, then the member may reasonably conclude that the customer has consented and may rely on the letter.

<sup>17</sup> Although "not held" orders are not subject to the restrictions in FINRA Rule 5320, front running a "not held" order that is not of block size may nonetheless violate FINRA Rule 2010. See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386

As initially proposed, FINRA would announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval, with the implementation date occurring no later than 90 days following publication of that Regulatory Notice.<sup>18</sup>

### III. Discussion of Comment Letters and FINRA Response

The Commission received one comment letter in support of the proposed rule change,<sup>19</sup> and one comment letter requesting revisions and clarifications to the proposed rule change.<sup>20</sup> As noted above, FINRA responded to the comments in its response dated August 29, 2012.

One commenter stated its belief that the extension of the Front Running Policy to cover any securities and financial instruments (not just option contracts and futures) was a logical approach and would better protect investors.<sup>21</sup> The commenter expressed concern with the exceptions provided in the Supplementary Material, and stated that FINRA should closely monitor the exceptions to ensure member firms are not using them as loopholes to engage in prohibited activities. In its response, FINRA stated that it intends to examine firms for compliance with, and fully enforce, the proposed rule.<sup>22</sup>

The other commenter raised three substantive issues with the proposal.<sup>23</sup> First, the commenter stated that the proposed rule change contained a flaw in that the barriers to the

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(February 17, 2011). If the “not held” order is of block size, the proposed rule change would apply to trading activity ahead of the order.

<sup>18</sup> See FINRA Response, supra note 5.

<sup>19</sup> See PIABA Letter, supra note 4.

<sup>20</sup> See SIFMA Letter, supra note 4.

<sup>21</sup> See PIABA Letter.

<sup>22</sup> See FINRA Response.

<sup>23</sup> See SIFMA Letter.

resumption of trading in the applicable security or related financial instrument – that the information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete – could interfere with a broker-dealers’ risk management activity, which could create problems in providing liquidity to the market.<sup>24</sup> The commenter requested clarity on what serves as the trigger for lifting trading restrictions and stated that trading restrictions should be lifted once the risk of a transaction has been transferred from the customer through the execution of the order.<sup>25</sup> According to the commenter, in the context of a block transaction where a member executes as a principal, the member provides liquidity to the market and is assuming the risks of the transaction. While executing a block transaction in an agency capacity, a member cannot trade ahead of its customer because the execution of the transaction eliminates the opportunity to do so. In certain situations where a type of security is not subject to prompt last sale reporting requirements, the commenter stated that the “stale or obsolete” threshold proposed by FINRA could prevent a dealer from performing necessary risk management activities while providing no additional benefit to the customer. Accordingly, the commenter requested confirmation that the execution of a block transaction by the member as principal or agent will be deemed to render the non-public information stale and obsolete for the purposes of front-running the customer, and permit the broker-dealer to transact in the security or related financial instrument, even if the applicable customer-related transaction has not become public.

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<sup>24</sup> See SIFMA Letter.

<sup>25</sup> Id.

FINRA responded that the “stale or obsolete” standard was intended to supplement, not replace, the existing dissemination standard.<sup>26</sup> FINRA noted that the trading restrictions in proposed FINRA Rule 5270 are linked to actual reporting and dissemination rather than by invoking the “stale or obsolete” standard when transactions are subject to prompt reporting requirements and the transaction reports are disseminated. Where there is no reporting and dissemination regime in place for the security or financial instrument, FINRA agreed with the commenter that, once the customer’s order is executed and the risk of the transaction has transferred from the customer to the firm, there would be no trading restrictions imposed by proposed FINRA Rule 5270.<sup>27</sup>

Second, the commenter requested additional clarification on whether the negative consent letter described in proposed Supplementary Material .04 would satisfy and be consistent with the “duty to refrain and disclose” described in NASD Notice to Members 05-51 (“NTM 05-51”) and FINRA Rule 5320.<sup>28</sup> Additionally, the commenter requested clarity on whether the duty to refrain and disclose described in NTM 05-51<sup>29</sup> arises on the basis of the same analysis as the obligations under proposed FINRA Rule 5270.

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<sup>26</sup> Under NASD IM-2110-3, information regarding a block transaction is considered publicly available “when it has been disseminated via the tape or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Act, an alternative trading system under Regulation ATS, or by a third-party news wire service.”

<sup>27</sup> See FINRA Response at 3.

<sup>28</sup> FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) generally prohibits a member that accepts and holds a customer order in an equity security without immediately executing the order from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

<sup>29</sup> NTM 05-51 addresses members’ obligations involving large, potentially market-moving orders received from a customer, such as VWAPs, institutional orders, and basket

In its response, FINRA agreed that, to the extent possible, proposed Supplementary Material .04 should be read consistently with NTM 05-51 and the obligations set out in FINRA Rule 5320.<sup>30</sup> FINRA stated that the proposed Supplementary Material was intended to acknowledge FINRA's previous guidance and the disclosure and consent provision in proposed Supplementary Material .04 mirrors FINRA Rule 5320. Moreover, FINRA stated that the duties set out in NTM 05-51 arise from the same concerns that FINRA Rule 5270 is designed to address. FINRA affirmed that proposal encapsulates the obligations established in NTM 05-51 with the difference noted by SIFMA: the disclosure obligation in proposed Supplementary Material .04 can be in the form of negative consent or, provided certain criteria are met, oral consent, which is not permitted by the duty to refrain and disclose as set out in NTM 05-51. FINRA further noted that, in addition to complying with the disclosure obligation in proposed Supplementary Material .04, the member must minimize any potential disadvantage to the customer or harm in the execution of the customer's order, and the member must not place its financial interests ahead of those of its customer. FINRA stated that, provided a member meets all of the criteria in proposed Supplementary Material .04, that member would have fulfilled its duty to refrain and disclose as set out in the Notice to Members.

Finally, the commenter requested a 180-day implementation period following publication of the applicable Regulatory Notice announcing the Commission's approval of the proposal,

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transactions. It states that, when a member receives such an order, it must "(1) refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interests ahead of those of its customer's and (2) if applicable, disclose in writing to the customer that the member intends to engage in hedging and other positioning activity that could affect the market for the security that is the subject of the transaction." It further states that the disclosure must be in the form of an affirmative consent letter, but the disclosure need not be on a transaction-by-transaction basis.

<sup>30</sup> See FINRA Response at 4.

rather than a 90-day implementation period, because members will need to make additional technology and system modifications to comply with the rule.<sup>31</sup> FINRA responded that it would extend the implementation date to within 180 days following publication of the Regulatory Notice announcing the Commission's approval of the rule.<sup>32</sup>

#### IV. Discussion and Commission Findings

After careful review of the proposal, the comment letters, and the FINRA Response, the Commission finds 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<sup>33</sup> and, in particular, the requirements 15A(b)(6) of the Act.<sup>34</sup> Specifically, the Commission finds that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The proposed rule change is intended to clarify the types of front running trading activity that FINRA believes are inconsistent with just and equitable principles of trade while also ensuring that members may continue to engage in transactions that do not present the risk of abusive trading practices that the rule is intended to prevent. The Commission finds that expanding the rule beyond options and security futures could enhance the protection of investors by further prohibiting the potential misuse of information from customer orders. Expanding the front running prohibition is reasonably designed to prevent fraudulent and manipulative acts and

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<sup>31</sup> See SIFMA Letter at 4.

<sup>32</sup> See FINRA Response at 5.

<sup>33</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).

<sup>34</sup> 15 U.S.C. 78o-3(b)(6).

practices, promote just and equitable principles of trade, and better protect investors and the public interest, while protecting imminent block transactions.

Moreover, the proposed rule change also would include three exceptions to the Front Running Policy: (1) transactions that the member can demonstrate are unrelated to the customer block order; (2) transactions that are undertaken to fulfill or facilitate the execution of the customer block order; and (3) transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange. The Commission finds that these exceptions should not unnecessarily restrict legitimate trading activities of members and are consistent with just and equitable principles of trade and the protection of investors and the public interest, and should not result in fraudulent and manipulative acts and practices. Specifically, transactions that the member can demonstrate are unrelated to the customer block order do not present the potential for abusive trading practices that can disadvantage a customer's order in violation of the rule, since such transactions would not be using the information from the customer's order. Moreover, transactions that are undertaken to fulfill or facilitate the execution of the customer block order similarly do not present the potential for abuse, as such transactions would be seeking to ensure the execution of a customer block order. Finally, permitting transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange would remove impediments to and perfect the mechanism of a free and open market and a national market system,<sup>35</sup> as it would help ensure that members would not unknowingly violate FINRA rules when such members rely on the rules of a particular national securities exchange.

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<sup>35</sup> 15 U.S.C. 78o-3(b)(6).

For the foregoing reasons, the Commission believes that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>36</sup> that the proposed rule change (SR-FINRA-2012-025), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>37</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>36</sup> 15 U.S.C. 78s(b)(2).

<sup>37</sup> 17 CFR 200.30-3(a)(12).