Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS JANUARY 11, 2012

SEC Approves New FINRA Best Execution and Interpositioning Rule

The Securities and Exchange Commission ("SEC") recently approved a rule change proposed by the Financial Industry Regulatory Authority, Inc. ("FINRA") relating to the "best execution" obligation of broker-dealers. The changes adopt existing NASD Rule 2320 (Best Execution and Interpositioning) and related Interpretive Materials as new FINRA Rule 5310 and related Supplementary Material with the following changes:

- Replacing the "Three Quote Rule" with Supplementary Material describing best execution obligations;
- Codifying existing guidance on regular and rigorous review of execution quality likely to be obtained from different market centers;
- Adding new Supplementary Material concerning orders for foreign securities with no US market; and
- Adding new Supplementary Material concerning customer instructions regarding order routing.

For additional information on the proposed rule change, please refer to our October 28, 2011, Client Alert available at http://www.chapman.com/media/news/media.1095.pdf. The SEC order approving the change and other information on the rule change is available at http://www.finra.org/Industry/Regulation/RuleFilings/2011/P124497. As of the date of this Client Alert, FINRA has not set an effective date for this rule change. FINRA should announce the implementation of the rule change in a Regulatory Notice no later than early March 2012, and the implementation date will be no later than 90 days following publication of that notice. Upon effectiveness, NASD Rule 2320 will no longer be applicable.

Background

NASD Rule 2320 requires FINRA member firms to use "reasonable diligence" in any transaction for or with a customer or a customer of another broker-dealer, to ascertain the best market for a security to be bought or sold at the price most favorable to that customer under prevailing market conditions. The five factors to be considered in determining whether a firm has used "reasonable diligence" are:

- character of the market for the security (e.g., price, volatility, liquidity, etc.);
- size and type of transaction;
- number of markets checked;
- accessibility of the quotation; and
- terms and conditions of the order as communicated to the member.

NASD Rule 2320 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, the staffing of order rooms, and the application of the best execution requirements to other parties. In addition, a significant part of NASD Rule 2320 is the "Three Quote Rule" found in NASD Rule 2320(f). The Three Quote Rule generally requires members that execute transactions in non-exchange-listed securities on behalf of customers to contact at least three dealers for quotes if there are fewer than two real-time quotations available on an inter-dealer quotation system. The Three Quote Rule establishes a minimum compliance standard, but satisfaction of its requirements does not itself mean that a broker-dealer has met its best execution obligation. FINRA adopted Interpretive Material 2320 (IM-2320) in 2006 to provide guidance on issues involving the term "market" for purposes of the rule and its application to debt securities and to broker-dealers that execute a customer's order against the broker-dealer's quote.

New FINRA Rule 5310 and the related Supplementary Material are based largely on NASD Rule 2320 and IM-2320. This Client Alert summarizes the primary changes from the existing rule and Interpretive Material.

Replacing the Three Quote Rule

In light of dramatic changes in the market for non-exchange-listed securities since the adoption of the Three Quote Rule, FINRA found that the current Three Quote Rule is overly prescriptive and can even hinder investor protection by causing significant delays in obtaining order execution. Accordingly, the rule change replaces the current Three Quote Rule with new Supplementary Material. The new Supplementary Material emphasizes a member's best execution obligations when handling an order involving an equity or debt security for which there is limited pricing information available. Members will be required to be especially diligent with respect to best execution obligations where there is limited quotation or other pricing information available regarding a security. The Supplementary Material also requires member firms to have written policies and procedures 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. The Supplementary Material notes that members should generally seek out other sources of pricing information or potential liquidity when handling orders for securities with limited pricing information, which might include obtaining quotations from other sources (e.g., other firms that the member previously has traded with in the security).

Guidance on Regular and Rigorous Review of Execution Quality

In past guidance, the SEC stated that in conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security. The requirement to regularly and rigorously examine execution quality flows from the SEC's acknowledgment that it may be impracticable for broker-dealers to provide individualized treatment for certain classes of orders. Instead, the SEC permitted broker-dealers to route those orders to a particular market center for handling and execution, so long as the routing broker-dealer periodically assesses the quality of competing markets and directs its order flow based on this assessment. The new FINRA changes codify existing SEC and FINRA guidance regarding a member's obligations when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers. FINRA's intent is that the new rule does not change these longstanding obligations, but simply codifies them as Supplementary Material to FINRA Rule 5310.

Supplementary Material on Foreign Securities with No US Market

NASD Rule 2320 does not specifically distinguish between orders for domestic securities and orders for foreign securities. This is the case even if there is no US market for a security. Because foreign jurisdictions do not have identical best execution requirements as those imposed by NASD Rule 2320 and may not have comparable pre-trade or post-trade transparency standards, the handling of orders for foreign securities with no US market can differ substantially from the handling of orders in securities that trade in the US. In recognition of these differences, the new rule includes Supplementary Material to assist in determining whether a member has satisfied its best execution obligations under a facts and circumstances analysis of "reasonable diligence" through the examination of specific factors, including the character of the market for the security and the accessibility of the quotation.

The new Supplementary Material notes that even though a foreign security may not trade in the US, members still have an obligation to seek best execution for customer orders involving the security. As a result, a member that handles customer orders for foreign securities that do not trade in the US 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 US 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 will be obligated to regularly review their policies and procedures to assess the quality of executions received and update or revise the policies and procedures as necessary.

Supplementary Material on Customer Order Routing Instructions

The Supplementary Material addresses situations where a customer, on an unsolicited basis, specifically instructs a member to route an order to a particular market for execution. Under those circumstances, the member would not be required to make a best execution determination beyond the specific instruction, but would be required to process the order promptly and in accordance with the terms of the order. Where a customer directs a 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 is directed.

Effective Date

As mentioned above, FINRA has not announced the effective date of the rule change but should do so by early March 2012 with the effective date occurring within 90 days of that announcement.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.