

**FINRA REQUESTS COMMENT ON PROPOSED FINRA RULE
ON BEST EXECUTION**

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued Regulatory Notice 08-80,¹ outlining proposed changes to its rule relating to best execution and interpositioning and requesting comment from interested parties.² The comment period expires January 29, 2009.

Summary

As part of the process of developing a new, consolidated rulebook incorporating many NASD Rules with those of the NYSE, FINRA is requesting comment on its proposal to adopt new FINRA Rule 5310 to address a member firm’s best execution obligations. FINRA Rule 5310 would be based largely on NASD Rule 2320 (Best Execution and Interpositioning), and IM-2320 (Interpretive Guidance with Respect to Best Execution Requirements) would be retained as Supplementary Material to new Rule 5310. The proposed amendments to be incorporated in the New Rule and Supplemental Material include:

- (1) adding a new provision providing that a FINRA member firm has met its best execution obligations regarding orders for foreign securities with no U.S. market if certain conditions are met;
- (2) replacing NASD Rule 2320(g) (the “Three Quote Rule”) with Supplementary Material that emphasizes that member firms must ensure that they meet their best execution obligations with respect to orders involving illiquid securities with non-transparent pricing;
- (3) modifying NASD Rule 2320(b) (the “Interpositioning Rule”) to delete the requirement that a member firm, when interposing a third party between the member and the best available market for the a security, show that the total cost or proceeds of a transaction were *better* than the prevailing inter-dealer market for the security, and replace it with a more general statement that the member be subject to the “best execution” standards of New Rule 5310 to use reasonable diligence to get the customer a resultant price that is “favorable as possible”³;

¹ Regulatory Notice 08-80, <http://www.finra.org/Industry/Regulation/Notices/2008/P117554>.

² Before becoming effective, a proposed rule change generally must be authorized for filing with the Securities and Exchange Commission (“SEC”) by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the Federal Register, unless it is designated for immediate effectiveness pursuant to the applicable SEC rule.

³ FINRA originally filed this proposed change with the SEC on November 27, 2007, but it has not yet been published for comment in the Federal Register. Regulatory Notice 08-80 indicates that FINRA is not seeking comment on the proposed amendments to the Interpositioning Rule.

- (4) adding Supplementary Material addressing a member firm's obligations when handling an order that the customer has instructed the firm to route to a particular market for execution; and
- (5) the codification of existing guidance on a member firm's obligation to regularly and rigorously review execution quality.

Proposed Changes

Proposed FINRA Rule 5310 and the Supplementary Material incorporate many of the existing provisions and concepts in NASD Rule 2320 and IM-2320, but do make some significant changes and codify existing guidance. The major amendments are outlined below.

Orders for Foreign Securities with No U.S. Market

Currently, NASD Rule 2320 does not distinguish between orders for domestic securities and orders for foreign securities, even if there is no U.S. market for the security. In the Regulatory Notice, FINRA cites the fact that markets in foreign jurisdictions often do not have best execution requirements identical to those imposed by Rule 2320 and, in many cases, may not have comparable pre-trade transparency.

FINRA proposes, as part of transferring NASD Rule 2320 into the Consolidated FINRA Rulebook, to adopt a new position addressing orders for foreign securities with no U.S. market. Under the proposed provision, a FINRA member firm would be deemed to have met its best execution obligations with respect to an order if:

- (1) the order is for a non-U.S.-traded security;⁴
- (2) the firm has 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;
- (3) the firm reviews those policies and procedures at least annually, or more frequently as appropriate, to assess the quality of the execution venues included in the firm's policies and procedures to determine (i) whether the venues provide for the most favorable terms reasonably available and (ii) whether the policies and procedures need to be updated or revised;
- (4) the firm has obtained its customers' consent⁵ to its policies and procedures regarding the handling of orders for non-U.S.-traded securities; and
- (5) the firm handles the order in accordance with its policies and procedures.

⁴ Defined 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 quotation medium in the U.S. at the time the member firm receives the order.

⁵ The Regulatory Notice indicates that consent may be obtained in any reasonable manner, including negative written consent.

Replace the Three Quote Rule

The Three Quote Rule, which was adopted over twenty years ago, and is currently found in NASD Rule 2320(g), generally requires member firms 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.

FINRA believes that although the concerns addressed by the Three Quote Rule are still valid, the current requirements in the Three Quote Rule are overly prescriptive and can often result in unnecessary delay in the execution of a customer's order. Thus, in light of changes in the market for non-exchange-listed securities and the several exclusions granted by FINRA, FINRA is proposing to replace the Three Quote Rule with Supplementary Material to proposed FINRA Rule 5310 that emphasizes a firm's best execution obligations when handling an order involving a non-exchange-listed security for which there is limited pricing information available.⁶ The Supplementary Material would require that FINRA member firms (i) have written policies and procedures on how the firm will determine the best market for such a security in the absence of multiple quotations, and (ii) document how they complied with those policies and procedures.

Currently, NASD Rule 2320(g)(2) provides that, if two or more quotation mediums permit quotation updates on a real-time basis for a non-exchange-listed security, members that display priced quotations on a real-time basis must display the same priced quotation in each medium. Paragraph (g)(4) of the rule includes definitions of terms used in paragraph (g)(2). Since it proposes to replace other sections of 2320(g), FINRA proposes to retain paragraph (g)(2) and the relevant definitions in paragraph (g)(4) by moving the provisions into the FINRA Rule 6400 Series (Quoting and Trading in OTC Equity Securities) as FINRA Rule 6480.

Modifying the Interpositioning Rule

Currently, NASD Rule 2320(b) provides that in any transaction for or with a customer, FINRA members shall not "interject a third party between the member and the best available market except in cases where the member can demonstrate that to his knowledge at the time of the transaction the total cost or proceeds of the transaction, as confirmed to the member acting for or with the customer, was better than the prevailing inter-dealer market for the security. A member's obligations to his customer are generally not fulfilled when he channels transactions through another broker-dealer or some person in a similar position, unless he can show that by so doing he reduced the costs of the transactions to the customer." In November of 2007,⁷ FINRA, citing technological advances, increased transparency in the equities markets and the development of electronic communications networks ("ECNs") since the Interpositioning Rule

⁶ The Supplementary Material would specifically note that, when handling orders for such securities, firms should generally seek out other sources of potential liquidity and may need to contact and obtain quotations from other dealers (e.g., other firms that the member firm has traded with in the past in the security).

⁷ See SR-FINRA-2007-024. <http://www.finra.org/Industry/Regulation/RuleFilings/2007/P037525>.

was adopted in 1968, proposed replacing the “better than” standard for pricing in 2320(b) with a requirement that such transactions simply be subject to the “best execution” standards of 2320(a). Those standards, which require using reasonable diligence to get the customer a resultant price that is as “favorable as possible,” would remain the same in FINRA Rule 5310(a).⁸ This proposed change to the Interpositioning Rule would be reflected in proposed new FINRA Rule 5310(a)(2).

Customer Instructions Regarding the Routing of Orders

FINRA is proposing to include Supplementary Material to proposed FINRA Rule 5310 in order to clarify that a member firm would not be required to make a best execution determination beyond the customer’s specific instruction, where the customer has, on an unsolicited basis, specifically instructed the firm to route its order to a particular market. The Supplementary Material would emphasize, however, that firms are still required to process the customer’s order promptly and in accordance with the terms of the order. The Supplementary Material would also make clear that where a customer has directed one FINRA member firm to route an order to another FINRA member firm, the exception for such customer directed orders would not apply to the second receiving broker-dealer to which the order was directed, and that receiving broker-dealer would continue to have best execution obligations to that customer order received from the first firm.⁹

The Supplementary Material would, however, retain the discussion in IM-2320 clarifying that a member's duty to provide best execution in any transaction "for or with a customer of another broker-dealer" does not apply in instances when another broker-dealer is simply executing a customer order against the member's quote and the duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the other broker-dealer to the member for the purpose of order handling and execution.¹⁰

Codification of the Regular and Rigorous Review of Execution Quality Requirement

FINRA is also proposing to add Supplementary Material to proposed FINRA Rule 5310 that it indicates would not alter existing requirements, but codify in a single place previously published

⁸ NASD Rule 2320(a) provides for various factors to be considered in determining if a member firm used reasonable diligence: (1) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; (2) the size and type of transaction; (3) the number of markets checked; (4) accessibility of the quotation; and (5) the terms and conditions of the order that result in the transaction, as communicated to the member and persons associated with the member. New Rule 5310(a) would retain those factors.

⁹ See subpart .07 in the Supplemental Material.

¹⁰ See subpart .04 in the Supplemental Material, which also retains the following from IM-2320: “This clarification is intended to draw a distinction between those situations in which the member is acting solely as the buyer or seller in connection with orders presented by a broker-dealer against the member's quote, as opposed to those circumstances in which the member is accepting order flow from another broker-dealer for the purpose of facilitating the handling and execution of such orders.”

SEC and FINRA guidance on a member firm's obligation to regularly and rigorously review execution quality likely to be obtained from different market centers.

Comments

FINRA will accept comments from member firms and other interested parties until January 29, 2009 and asks persons to submit their comments by:

- > Emailing comments to pubcom@finra.org; or
- > Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

We will update our clients and friends with any further developments in the approval process for this new proposed Rule.

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If you have any questions regarding this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com), or the attorney with whom you regularly work.

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