

**FINRA PROPOSES EXPANDING PROHIBITIONS ON
FRONT RUNNING OF BLOCK TRANSACTIONS**

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued Regulatory Notice 08-83,¹ outlining proposed changes to its prohibitions on front running of block transactions and requesting comment. The comment period expires February 6, 2009.²

Summary

As part of the process of developing a new rulebook consolidating many NASD Rules with those of the NYSE, FINRA is requesting comment on its proposal to adopt its current policy prohibiting front running of block transactions,³ found in NASD Interpretive Material (“IM”) 2110-3, as new FINRA Rule 5270 and to expand its application.

Proposed amendments include broadening the scope of the Rule beyond options and security futures to other types of derivatives, financial instruments and financial contracts, as well as adopting Supplementary Material to the Rule to codify exceptions to the prohibitions.

Background

Currently, NASD IM-2110-3 provides that it is conduct inconsistent with just and equitable principles of trade for a FINRA member firm or an associated person of a member firm to buy or sell security futures or options for accounts in which the firm or associated person has an interest when the firm or associated person has material, non-public information concerning an imminent block transaction in the underlying security. The same prohibition applies in the reverse situation, where a member firm or associated person proposes to buy or sell an underlying security when such firm or associated person has material, non-public information regarding a block transaction in an option or security future on that underlying security. IM-2110-3 also prohibits providing material, non-public information concerning an imminent block transaction to customers who then trade on the basis of the information. The prohibitions apply until the information concerning the block transaction has been made publicly available.

¹ Regulatory Notice 08-83, <http://www.finra.org/Industry/Regulation/Notices/2008/P117630>.

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 IM-2110-3 and the proposed Supplementary Material to new Rule 5270 define a block transaction as one generally involving 10,000 or more securities.

Proposed Amendments

FINRA proposes adopting IM-2110-3 as FINRA Rule 5270 and amending it in several ways to broaden its scope.

Prohibitions to Include “Related Financial Instruments”

FINRA proposes extending the prohibitions in the Rule to apply to trading not only in options and security futures, but also to the security that is the subject of the block transaction or a “related financial instrument.” Related financial instrument is defined in the proposed Rule to mean “any option, derivative, or other financial instrument overlying a security, the value of which 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.”⁴

As is the case with options and security futures currently in IM-2110-3, the reverse situation would also be prohibited; where the imminent block transaction itself involves a related financial instrument, the proposed rule would prohibit trading in the underlying security.

Termination of Prohibitions When Information Becomes Stale

Because there may never be any publicly available trading information concerning some of the related financial instruments to be subject to Rule 5270, FINRA is also proposing that the prohibitions would terminate not only as in IM-2110-3, when the material, non-public information becomes publicly available, but also when such information “otherwise becomes stale or obsolete.”

Revised Exceptions

FINRA proposes deleting several existing provisions in the IM-2110-3 and adopting new provisions as Supplementary Material to proposed FINRA Rule 5270. Specifically, FINRA proposes deleting the existing exceptions in IM-2110-3 for certain transactions in automatic execution systems and for positioning the other side of certain orders when a member firm receives a customer’s block order relating to both an option and the underlying security or a security future and the underlying security. FINRA proposes replacing these specific exceptions with new Supplementary Material addressing permitted transactions. The Supplementary Material will provide that Rule 5270 does not preclude trading activity executed for the purpose of fulfilling the customer block order or trading activity where the member can demonstrate it is

⁴ The Regulatory Notice indicates that the proposed expansion of the Rule to include all related financial instruments is intended to capture those instruments (in addition to securities) that could be used to take advantage of the knowledge of an imminent block transaction, and gives as examples equity swaps and convertible debt.

unrelated to the material, non-public information received in connection with the customer order.⁵

The proposed Supplementary Material also provides that a member firm may engage in hedging and other positioning activity that could affect the market for the security that is the subject of the customer's block order where the firm has received the customer's affirmative written consent prior to receipt and/or execution of the order.⁶ The firm must however still refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the firm's financial interests ahead of those of its customer.

FINRA also proposes to specify in the Supplementary Material that trading ahead is permitted to facilitate the execution, on a riskless principal basis, of a customer's block order. A member that relies on this exception must give the customer's order the same per-share price at which the member accumulated or sold the shares to satisfy the customer's order, exclusive of any markup or markdown, commission equivalent or other fee.

The proposed Supplementary Material also provides that although the prohibitions in Rule 5270 are limited to imminent block transactions, the front running of other types of orders that place the financial interests of the member or persons associated with the member ahead of those of its customer or that involve the misuse of the knowledge of an imminent customer order may violate other FINRA rules, including Rule 2010, or provisions of the federal securities laws.

⁵ See Proposed section .04 in the Supplementary Material to Rule 5270, which provides "for example, the prohibition in Rule 5270 does not apply to (a) transactions related to a prior customer order; (b) bona fide hedge transactions that the member can demonstrate are unrelated to the material, non-public information received in connection with the customer order and where the member has information barriers established to prevent internal disclosure of such information; (c) "black box" orders where the member has no actual knowledge that the customer order has been routed for execution; (d) trades to correct bona fide errors; and (e) odd-lot transactions to offset odd-lot orders."

⁶ The Proposed Supplementary Material codifies a long-standing FINRA position that member firms are permitted to trade ahead of a customer's block order when the purpose of such trading is to fulfill the customer order, the customer has authorized such trading, and the firm has disclosed to the customer that it may trade ahead of, or alongside of, the customer's order. See NASD Notices to Members 97-57 and 05-51. As stated in Notice to Members 05-51, which discussed volume-weighted average price transactions, member firms need not obtain affirmative consent on a transaction-by-transaction basis; however, firms should at least annually take steps to have their customers reaffirm their consent. The Regulatory Notice asks for comment as to whether new Rule 5270 should have a specific reaffirmation requirement and, if so, what the frequency should be.

Comments

FINRA will accept comments from member firms and other interested parties until February 6, 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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