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## SEC Approves New FINRA Rule 5270: A Significant Expansion of FINRA's Prohibitions on Front Running Block Transactions

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On September 4, 2012, the Securities and Exchange Commission ("SEC" or "Commission") approved the Financial Industry Regulatory Authority's ("FINRA") Rule 5270, which replaces and significantly expands the current prohibitions in NASD IM 2110-3 ("NASD Front Running Policy") on member firms' front running their customers' block transactions.<sup>1</sup> In particular, new Rule 5270 (or "the Rule") expands the front running prohibitions to apply to (i) *all* securities (not just equities), and (ii) other financial instruments and contracts (not just options and security futures) that overlay a security that is the subject of an imminent block transaction and that have a value that is materially related to (or otherwise act as a substitute for) the underlying security. The Rule expands the front running prohibition when the imminent block transaction involves a related financial instrument, and would prohibit trading in the underlying security in these cases. Finally, the Rule explicitly extends the front running prohibition to include trading in the same security or related financial instrument that is the subject of an imminent block transaction. At the same time that FINRA expanded the scope of its block front running prohibitions, FINRA also expanded the categories of "exemptions" from these prohibitions. These expanded prohibitions, and the new exemptions from the Rule, are described more fully below. FINRA also confirmed that Rule 5270's front running prohibitions do not apply to transactions involving "exempted securities" (e.g., government securities).<sup>2</sup> The Rule will be effective following FINRA's publication of a Regulatory Notice.

### I. Expansion of FINRA's Prohibitions on Front Running Customers' Block Trades

As noted above, Rule 5270 retains many components of the current front running prohibitions, but expands these prohibitions in two significant ways.

- ***Expansion of the front running prohibition to trading in all securities, including fixed income securities, and "related financial instruments."*** FINRA's front running prohibition currently applies to purchases or sales of (i) an option or security future when a member firm has material, nonpublic information concerning an imminent block transaction in the underlying security, and (ii) an underlying security when a member firm has material, nonpublic information concerning an imminent block transaction in an option or security

future overlying that security. In contrast, Rule 5270 applies to *all* securities, as well as “related financial instruments,” that are the subject of an imminent block transaction. This means that FINRA’s “block transaction” front running prohibitions will now apply (subject to the exemptions noted below) to: purchasing or selling a security or related financial instrument when a member firm has material, nonpublic market information concerning an imminent block transaction in that security, a related financial instrument, or a security underlying the related financial instrument. The front running prohibition applies until the block transaction has been “made publicly available” or “has otherwise become stale or obsolete.”

- The Rule defines “related financial instrument” very broadly, to include derivatives and other financial contracts, *i.e.*: “any option, derivative, security-based swap, 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.”<sup>3</sup>
- The Rule defines “*publicly available*” to mean trade information that has been disseminated via (i) a last sale reporting system or high-speed communication line of one of those systems, or a similar system of a national securities exchange, (ii) an alternative trading system, or (iii) a third-party news wire service. The requirement that information concerning the block transaction be made publicly available will not be satisfied until the entire transaction has been completed and publicly reported. Whether information becomes “stale and obsolete” depends upon the particular facts and circumstances of each transaction, 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.”<sup>4</sup> In FINRA’s response to commenters, it noted that firms may not rely on the “stale and obsolete” standard if there is a transparency regime in place for the security or related financial instrument (*i.e.*, transactions are subject to prompt reporting requirements and transaction reports are disseminated, such as debt securities subject to TRACE reporting and dissemination). In these cases, firms cannot rely on the “stale and obsolete” standard, but rather must wait for the block transaction to be publicly reported (or rely on an exemption from the prohibition).
- In response to one commenter’s concern that the term “*security*” is too broad and may include fixed income securities (which do not easily fit into the “block transaction” definition), FINRA confirmed that Rule 5270 is, in fact, intended to cover all securities, including fixed income securities.<sup>5</sup>

- ***Expansion of the front running prohibitions to cover the subject security or related financial instrument.*** Rule 5270 also explicitly extends the front running prohibition to include trading in the same security or related financial instrument that is the subject of an imminent block transaction.

## II. New Exemptions from Front Running Restrictions

FINRA Rule 5270 Supplemental Material .04 replaces the existing exemptions from the current NASD Front Running Policy to permit the following three categories of transactions:

- ***Transactions that are unrelated to the customer block order (Supplementary Material .04(a)).*** Such transactions include those where the member firm has established information barriers to prevent disclosure of customer information. FINRA has noted that, in addition to more traditional information barriers addressing communication between trading units, firms may also use automated systems, such as trades through a “black box,” where orders are handled without the knowledge of a person associated with the member who may be trading in the same security.<sup>6</sup> However, if an associated person entering the order into the “black box” has knowledge or access to information relating to that order, that associated person and others with similar access would be subject to the restrictions of the Rule and could not continue to trade.<sup>7</sup> This category of permitted transactions also would include the following: (i) transactions in the same security related to a prior customer order in that security; (ii) transactions to correct bona fide errors; and (iii) transactions to offset odd-lot orders.
- ***Fulfilling or Facilitating Transactions (Supplementary Material .04(b)).*** Rule 5270 does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, the customer block order. Firms relying on this exception, however, must: (i) minimize any potential disadvantage or harm in the execution of the customer’s order; (ii) not place the member’s financial interests ahead of those of its customer; and (iii) obtain the customer’s consent to such trading activity. Customer consent may be obtained in one of three ways: (i) affirmative written consent; (ii) use of a negative consent letter; or (iii) orally, on an order-by-order basis. In response to one commenter’s concerns, FINRA confirmed that Supplementary Material .04 “was intended to acknowledge FINRA’s previous guidance” and “should be read consistently with” the “duty to refrain and disclose” described in NASD Notice to Members 05-51 and FINRA Rule 5320.<sup>8</sup> However, firms should note that transactions for other purposes besides fulfilling or facilitating the execution of the customer block order, such as transactions subject to guidance under NASD Notice 05-51, may still require affirmative written consent.<sup>9</sup>
- ***Exchange Transactions (Supplementary Material .04(c)).*** This exemption was added to address concerns from the NYSE about trading activity conducted in compliance with certain NYSE, NYSE Arca, and NYSE Amex rules that permit trading based on information related to imminent block transactions when the information has entered the market in other ways, such as through gapped quotes or disclosure to a trading crowd in the context of anticipatory hedging with respect to options, which is permitted by the options exchanges.<sup>10</sup> In response, FINRA added this exemption and confirmed that Rule 5270 is not intended to prohibit legitimate trading activity or supersede other self-regulatory organization and exchange rules.<sup>11</sup>

### III. Implementation of New Front Running Rule

FINRA will announce the implementation date of Rule 5270 in a Regulatory Notice to be published no later than 90 days following the Commission’s September 4, 2012 approval of the new rule. The

implementation date will be no later than 180 days following publication of such Regulatory Notice.<sup>12</sup>

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<sup>1</sup>FINRA Regulatory Notice 08-83 (Dec. 2008) (initial FINRA Board of Governors proposal of Rule 5270); Securities Exchange Act Release No. 67,079 (May 30, 2012), 77 Fed. Reg. 33,522 (June 6, 2012) (FINRA's proposed rule change submitted to the SEC) ("SEC Proposing Release"); Securities Exchange Act Release No. 67,774 (Sept. 4, 2012), 77 Fed. Reg. 55,519 (Sept. 10, 2012) (SEC's approval of FINRA's proposal, as modified by Amendment No. 1) ("SEC Approving Release").

<sup>2</sup>FINRA Rule 0150 (defining and providing guidance on "exempted securities"). Notwithstanding their exclusion from the scope of Rule 5270, exempted securities would continue to be subject to FINRA Rule 2010. SEC Approving Release, fn. 6.

<sup>3</sup>FINRA Rule 5270(c)).

<sup>4</sup>SEC Approving Release, fn.13.

<sup>5</sup>Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (Feb. 27, 2009) ("2009 SIFMA Letter"); SEC Proposing Release, at 33,526.

<sup>6</sup>SEC Approving Release, fn. 14.

<sup>7</sup>Id.

<sup>8</sup>Letter from Sean Davy, Managing Director, Corporate Credit Markets Division, SIFMA (July 9, 2012) ("2012 SIFMA Letter"); SEC Approving Release, at 55,522.

<sup>9</sup>2009 SIFMA Letter; 2012 SIFMA Letter.

<sup>10</sup>Letter from James F. Duffy, Interim Chief Executive Officer, NYSE Regulation, Inc. to Thomas Gira, Executive Vice President, FINRA (July 22, 2009); SEC Proposing Release, at 33,525.

<sup>11</sup>Id.

<sup>12</sup>Letter from Mr. Brant Brown, Associate General Counsel, FINRA to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 29, 2012); SEC Approving Release, at 55,521,

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