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FINRA Rule 5270 FAQs: Front Running of Block Transactions

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Introduction and Overview

Recently, FINRA adopted new Rule 5270 to address front running of block transactions, and to replace NASD IM-2110-3. As further described below, the front-running prohibitions in Rule 5270 are significantly broader than current IM-2110-3.

Below we have provided a list of what we view as frequent questions relating to the new rule.

When Does the Rule Take Effect?

FINRA Rule 5270 will take effect on June 1, 2013.

What Is Prohibited by the Rule?

FINRA Rule 5270 provides that no FINRA member broker-dealer may cause an order to buy or sell a security or a "related financial instrument" to be executed when that member has material, non-public market information concerning an imminent block transaction in that security, a related financial instrument or a security underlying the related financial instrument prior to the time information concerning the block transaction has been made publicly available, or has otherwise become stale or obsolete. Rule 5270 replaces and considerably broadens current NASD interpretive material IM-2110-3, which prohibits front running of block transactions in equity securities.

The rule generally applies to proprietary or discretionary trading by the FINRA member. Specifically, it applies to orders caused to be executed for (1) any account in which the member or person associated with the member has an interest, (2) any account with respect to which the member or person associated with the member exercises investment discretion, and (3) any account of customers or affiliates of the member when the customer or affiliate has been provided such material, non-public market information by the member or any person associated with the member.

FINRA Rule 5270 does not apply to orders or transactions involving government securities. FINRA Rule 0150(c) lists the rules applicable to transactions in, and business activity relating to, "exempted securities," which include government securities. Rule 5270 is not included in that list of rules applicable to transactions in, and business activities relating to, "exempted securities" and therefore does not apply to orders or transactions involving "exempted securities."[1] Note, however, that actions relating to front running and similar conduct occurring in the government securities markets continue to be covered by FINRA's general rule regarding high standards of commercial conduct, Rule 2010.

What Is a Block Trade?

Under applicable FINRA guidance, a "block trade" would generally be described as a transaction of a large quantity of stock or in a large dollar amount. In general, 10,000 shares are considered to be a "block."

The term "block transaction" is currently found at IM-2110-3, and its general scope has been retained by FINRA Rule 5270. The Rule's Supplementary Material .03 provides that, in the context of equity securities, a transaction involving 10,000 shares or more of a security, an underlying security, or a related financial instrument overlying such number of shares is generally deemed to be a block transaction, although a transaction of fewer than 10,000 shares could also be considered a block transaction. Further, a block transaction that has been agreed upon does not lose its identity as a block transaction by virtue of partial executions, which themselves are not of block size. While the definition of "block transaction" with respect to equity securities remains similar to the current standard, it is unclear, however, what empirical and qualitative standards will be used to determine what constitutes a block transaction in respect of fixed-income markets and in respect of other related financial instruments. For example, a fixed dollar amount would appear to be an overbroad measure. Further, FINRA's supplementary material suggests that the regulator's after-the-fact review may be more sensitive than a fixed dollar amount would allow.

What Is a "Related Financial Instrument"?

Under Rule 5270(c), the term "related financial instrument" is defined as 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. This definition expands FINRA's Front Running Policy to cover most types of financial instruments, including derivative instruments. The expansion of the Rule's terms to derivatives and other "related financial instruments" means that FINRA member firms must now implement policies and procedures to either ensure that information barriers prevent the flow of information regarding imminent block transactions across trading desks, or that trading in multiple instruments is controlled in accordance with the Rule.

[1] The term "exempted securities," for the purposes of Rule 0150, has the same meaning as that in Section 3(a)(12) of the Securities Exchange Act of 1934.

What Is Imminent Knowledge of "Material Terms"?

Under Supplementary Material .01, the violative practices in FINRA Rule 5270 may include transactions that are executed based upon knowledge of less than all of the terms of the block transaction, so long as there is knowledge that all of the "material terms" of the transaction have been or will be agreed upon imminently. FINRA interpretative guidance suggests that a firm need not know every detail of a potential block transaction for the front running prohibitions to attach. Exactly when such prohibitions commence will depends upon the facts and circumstances of the communications between the firm and its customer. In this respect, it is again difficult to know how the regulator will interpret when all of the material terms of a transaction become known, particularly if there is evidence of wavering or fluctuating terms. Further, the question of what constitutes "imminent" knowledge will be highly fact-specific, and may even in some cases be influenced by the past practices of the particular clients.

Once Trading Is Halted, When Can a Firm Recommence Trading in the Security or a Related Financial Instrument?

FINRA Rule 5270(a) only applies to prohibit trading "prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete." Conversely, a firm can recommence trading in the security or a related financial instrument when the information concerning the block transaction has been made "publicly available or has otherwise become stale or obsolete."

Supplementary Material .02 provides that "[i]nformation as to a block transaction shall be considered to be publicly available when it has been disseminated via a last sale reporting system or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Exchange Act, an alternative trading system under SEC Regulation ATS, or by 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 block transaction has been completed and publicly reported."

When Does Information Regarding a Block Transaction Become Stale or Obsolete?

Whether information has become "stale or obsolete" for purposes of Rule 5270 will depend upon the particular facts and circumstances involved, including specific information the member firm has regarding the transaction. This 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. In its response to comments by the Securities Industry and Financial Markets Association ("SIFMA"), FINRA stated that the "stale or obsolete" standard supplements a dissemination standard; dissemination of trade information, however, also relieves a firm of the Rule's trading prohibitions. Consequently, FINRA has stated that where there is a transparency regime in place with respect to the security or financial instrument (i.e., transactions are subject to prompt reporting requirements and the transaction reports are disseminated), the trading restrictions in Rule 5270 are linked to actual reporting and dissemination rather than by invoking the "stale or obsolete" standard. Note that FINRA's view is that this would include debt securities subject to TRACE reporting

requirements, even though the TRACE reporting requirements generally allow for up to 15 minutes to report transactions in corporate and agency debt securities.[2]

What Transactions Are Permitted Once Trading Is Prohibited?

Supplementary Material .04 sets forth three broad categories of permitted transactions: (i) transactions that a firm can demonstrate are unrelated to the customer block order (Supplementary Material .04(a)), (ii) transactions that are undertaken to fulfill or facilitate the execution of the customer block order (including hedging or block positioning) (Supplementary Material .04(b)), and (iii) transactions that are executed, in whole or in part, on a national securities exchange and comply with the marketplace rules of that exchange (Supplementary Material .04(c)).

How Will Firms Implement Surveillance?

The breadth of the Rule's prohibition means that firms will need to improve their systems to, among other things, account for and flag trading in an option, derivative 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, or alternatively ensure that efficient physical and other business systems prevent knowledge of block transactions by broker-dealer personnel that trade related financial instruments. Further, firms will need to be cognizant that the "imminent" standard places priority not only on the input of information into firm systems at a time prior to the transaction, but on the sensitivity of individual traders to the prohibition and to the initiation of trading prohibitions.

Training of firm personnel will therefore be important in respect of creating awareness of the rule and creating conservatism around its implementation within firms. Further, a good training program will serve as evidence of the firm's standards and practices in respect of compliance.

[2] In its comment letter, SIFMA suggested that the transfer of risk from the customer to the member broker-dealer should relieve the member of the Rule's prohibitions. In response, FINRA responded that: "Where there is no reporting and dissemination regime in place for a security or related financial instrument, 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 Rule 5270." See FINRA Response to comments (Aug. 29, 2012), located at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p160236.pdf.

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