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Thinking Ahead: Preparing for Implementation of FINRA's New Front-Running Rule 5270

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On September 4, 2012, the Securities and Exchange Commission (the “SEC”) approved FINRA’s new front-running rule, Rule 5270 (“Rule 5270” or “the Rule”).¹ The Rule replaces NASD Interpretive Material IM-2110-3, which, generally speaking, applies only to equities and equity options. The Rule is notable in its scope: it is applicable not only to equity securities but to all securities, including fixed-income securities, but also to “related financial instruments”, a broadly defined category that includes derivatives.

FINRA published Regulatory Notice 12-52 announcing SEC approval.² In that Regulatory Notice, FINRA set an effective date for the Rule of **June 1, 2013**.

In previous notes, we have summarized the Rule and some of its frequently asked questions.³

With the effective date now approximately three months away, many firms are now adding implementation of the Rule to their already overburdened compliance plate. Firms are

- ¹ The adopting release can be found at “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as modified by Amendment No. 1, to Adopt Existing NASD IM-2110-3 as New FINRA Rule 5270 (Front Running of Block Transactions) with Changes in the Consolidated FINRA Rulebook”, SEC Release 34-67774 (Sept. 4, 2012) (“Adopting Release”). The Adopting Release is available at <http://www.sec.gov/rules/sro/finra/2012/34-67774.pdf>.
- ² See FINRA Regulatory Notice 12-52, “SEC Approves Consolidated Front Running Rule; Effective Date: June 1, 2013” (December 2012). FINRA regulatory notices are available at www.finra.org.
- ³ For more information regarding the Rule, you may refer to “FINRA Rule 5270 FAQs: Front Running of Block Transactions” (Jan. 9, 2013), available at <http://www.shearman.com/finra-rule-5270-faqs-front-running-of-block-transactions-01-09-2013/>.

discovering that the breadth of the new Rule is creating some daunting challenges in respect of implementation.

The purpose of this note is to provide a brief summary of the Rule, and to discuss some initial steps that firms are taking in consideration of implementation.

Summary of Rule 5270

General Prohibition against “front-running”

The Rule states that no member or person associated with a member shall cause to be executed an order to buy or sell a security or a related financial instrument when the member or person associated with the member causing the order to be executed 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 available⁴ or has otherwise become stale or obsolete.

The Rule 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 firm.

Scope: The Rule Applies to All Securities and to “Related Financial Instruments”

The Rule applies to all securities, including fixed-income securities, and “related financial instruments” that are the subject of an imminent block transaction. The Rule defines “related financial instruments” 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.

Exceptions⁵

The Rule provides three basic exceptions. First, the Rule does not preclude transactions that the member can demonstrate are unrelated to the material, non-public market information received in connection with the customer order. These types of transactions may include transactions:

- where the member has information barriers established to prevent internal disclosure of such information;
- in the same security related to a prior customer order in that security;
- to correct bona fide errors; or

⁴ Publicly available means “[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.”

⁵ See Supplementary Material .04.

- to offset odd-lot orders.

Second, the Rule does not preclude transactions undertaken for the purpose of fulfilling, or facilitating the execution of, the customer block order. However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the member must minimize any potential disadvantage or harm in the execution of the customer's order, must not place the member's financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity.

A member may obtain its customer's consent through affirmative written consent or through the use of a negative consent letter. The negative consent letter must clearly disclose to the customer the terms and conditions for handling the customer's orders; if the customer does not object, then the member may reasonably conclude that the customer has consented and the member may rely on such letter for all or a portion of the customer's orders.

In addition, a member may provide clear and comprehensive oral disclosure to and obtain consent from the customer on an order-by-order basis, provided that the member documents who provided such consent and such consent evidences the customer's understanding of the terms and conditions for handling the customer's order.

Finally, the Rule does not apply if the member's trading activity is undertaken in compliance with the marketplace rules of a national securities exchange and at least one leg of the trading activity is executed on that exchange.

Preparing for implementation of Rule 5270

What is a Block?

Some firms are commencing their implementation activities by considering what constitutes a block transaction for purposes of the Rule. In this regard, the Rule's interpretive guidance notes that, with respect to equity transactions, a general guideline for the definition of "block transaction" is a transaction of 10,000 shares or more.⁶ The applicable interpretive guidance under the Rule states, however, that the 10,000 share guideline is just that, and that firms must consider the possibility that a transaction of less than 10,000 shares would be considered a "block" transaction for purposes of the Rule.

In the absence of a precise definition for "block transaction" across products, firms have been analyzing this definition internally. In general, because the prohibitions of IM-2110-3 already apply to block transactions in equity securities, firms are more comfortable with this aspect of the Rule as it applies to equity securities. With respect to fixed income, however, firms are considering a number of methods to determine what constitutes "block" size, including drawing mathematical analogies to the 10,000-share guidance on the equity side, and using the firm's own trading data to determine what transaction size gives rise to a material transaction, at least in terms of market movement. In this respect, some firms are reporting that implementation of the technology and systems required to monitor transaction size as against an inherently variable definition can be quite complex.

⁶ See Supplementary Material .03, which states, "[i]n 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 be considered a block transaction. A block transaction that has been agreed upon does not lose its identity as such by arranging for partial executions of the full transaction in portions which themselves are not of block size if the execution of the full transaction may have a material impact on the market."

What is a “Related Financial Instrument”?

Another key issue is the scope of the Rule. In particular, the definition of “related financial instrument” is broad enough to cover considerable ground. Here, some firms are analyzing two separate questions: first, what financial instruments are traded by the firm that have value that is materially related to, or that otherwise act as a substitute for a security, and second, what aggregation units and other information barriers does the firm have in place between groups of firm personnel that regularly transact in securities and their related financial instruments. The first question relates to the possible application of the Rule to the firm’s current trading, and the second question relates to the possibility that, in some circumstances, groups can be segregated in a manner that permits the unrelated trading of securities and their related financial instruments through such segregation. In this respect, some firms are reporting that implementation of technology and systems required to monitor trading in securities and their related financial instruments can be complex.

What is “Imminent Knowledge” of a Transaction?

By its terms, the Rule applies prior to the time that a firm receives an order, with the prohibitions of the Rule commencing at the time that a firm has “imminent” knowledge of the block transaction. In this regard, FINRA’s Adopting Notice states that “The violative practices in 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.”⁷ Firms are considering how to define and monitor “imminent” transactions.⁸ With respect to the definition of “imminence”, some firms are implementing training programs that are intended to sensitize firm personnel to the factors that give rise to a conclusion that a block transaction is imminent. These factors include not only agreement as to volume and price, but also situation-specific factors such as the trading history of the specific client with whom the block transaction is being discussed.

What Kind of Surveillance and Training are Firms Considering?

As noted above, while firms are focused on the technology and written supervisory procedure changes that must be implemented in order to meet the Rule’s requirements, training and monitoring programs are at the center of some firms’ compliance efforts. In particular, sales and trading personnel need to be sensitized to the aspects of the Rule that are new or expanded in scope, and to when and what procedures must be followed and/or triggered in order to ensure that the Rule’s prohibitions are respected. Also important is the frequency and manner by which compliance with the Rule is monitored.

⁷ The Adopting Release at footnote 3.

⁸ Some firms are also considering how certain prospective regulations regarding the audio taping of trading desk personnel may impact surveillance in respect of when a transaction is “imminent”.

Next Steps

With approximately three months until the implementation date, it is now time for firms to work on implementation of the Rule. For some firms, the Rule's new and expanded requirements are giving rise to complex implementation of new technology, training, written supervisory procedure and monitoring.

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