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For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>12</sup>

**Kevin M. O'Neill,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–65895; File No. SR–FINRA–2011–052]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change To Adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material (“IM”) 2320 as FINRA Rule 5310 in the Consolidated Rulebook

December 5, 2011.

#### I. Introduction

On October 4, 2011, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) <sup>1</sup> and Rule 19b–4 thereunder, <sup>2</sup> a proposed rule change to adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material (“IM”) 2320 (Interpretive Guidance with Respect to Best Execution Requirements) as a FINRA rule in the consolidated FINRA rulebook with four notable changes. The proposed rule change was published for comment in the **Federal Register** on October 21, 2011. <sup>3</sup> The Commission received one comment letter on the proposal. <sup>4</sup> FINRA filed a response to

this comment on December 1, 2011. <sup>5</sup> This order approves the proposed rule change.

#### II. Description of the Proposal

As part of the process of developing a new consolidated rulebook (“Consolidated FINRA Rulebook”), <sup>6</sup> FINRA is proposing to adopt NASD Rule 2320 (Best Execution and Interpositioning) and IM–2320 (Interpretive Guidance with Respect to Best Execution Requirements) as a FINRA rule in the consolidated FINRA rulebook with four notable changes. <sup>7</sup> Specifically, the proposed rule change would combine and renumber NASD Rule 2320 and IM–2320 as FINRA Rule 5310 in the Consolidated FINRA Rulebook.

##### *Current NASD Rule 2320 and IM–2320*

NASD Rule 2320 currently requires a member, in any transaction for or with a customer or a customer of another broker-dealer, to use “reasonable diligence” to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule identifies five factors that are among those to be considered in determining whether the member has used reasonable diligence. <sup>8</sup> The rule also includes provisions related to interpositioning (i.e., interjecting a third party between the member and the best available market), the use of a broker’s broker, <sup>9</sup> the staffing of order rooms, and

<sup>5</sup> See Letter from Brant K. Brown, Associate General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated December 1, 2011 (“FINRA Response to Comment”).

<sup>6</sup> The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (“Dual Members”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice*, March 12, 2008 (Rulebook Consolidation Process).

<sup>7</sup> As part of adopting the NASD rule as a FINRA rule, FINRA has also proposed various technical and conforming changes.

<sup>8</sup> These five factors are: (1) The character of the market for the security; (2) the size and type of transaction; (3) the number of markets checked; (4) the accessibility of the quotation; and (5) the terms and conditions of the order as communicated to the member.

<sup>9</sup> The proposed rule change moves part of the provision concerning the use of a broker’s broker from paragraph (b) of the rule to Supplementary Material .05.

the application of the best execution requirements to other parties.

In addition to these provisions, NASD Rule 2320(f) (commonly referred to as the “Three Quote Rule”) generally requires members 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 subject to certain exclusions. <sup>10</sup> The Three Quote Rule establishes a minimum standard, and compliance with the Three Quote Rule, in and of itself, does not mean that a member has met its best execution obligations under NASD Rule 2320. <sup>11</sup>

IM–2320 was adopted in 2006 to codify interpretive guidance that FINRA staff had provided involving compliance with NASD Rule 2320. <sup>12</sup> Specifically, IM–2320 addresses issues involving the term “market” for purposes of the rule as well as the application of the rule to debt securities and to broker-dealers that are executing a customer’s order against the broker-dealer’s quote.

##### *Proposed Adoption and Changes to NASD Rule 2320 and IM–2320 as FINRA Rule 2310*

FINRA is proposing to adopt NASD Rule 2320 (Best Execution and Interpositioning) and IM–2320 (Interpretive Guidance with Respect to Best Execution Requirements) as FINRA rule 5310 in the Consolidated FINRA Rulebook with four notable changes, discussed in turn.

##### (1) Three Quote Rule

Although the original concerns the Three Quote Rule was designed to address are still valid, FINRA represents that the current requirements in the Three Quote Rule, even with the various exclusions, are overly prescriptive and can often result in unnecessary delay in the execution of a customer’s order or impose requirements that do not benefit the customer. <sup>13</sup> Accordingly, rather than maintain the Three Quote Rule and the various exclusions in their current format, the proposed rule change replaces the Three Quote Rule with Supplementary Material emphasizing a member’s best execution obligations

<sup>10</sup> The Three Quote Rule does not apply, for example, when two or more priced quotations for a non-exchange-listed security are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis. Also excluded from the Three Quote Rule are certain transactions in non-exchange-listed securities of foreign issuers that are part of the FTSE All-World Index.

<sup>11</sup> See NASD *Notice to Members* 00–78 (November 2000).

<sup>12</sup> See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006).

<sup>13</sup> See Notice at 65550.

<sup>12</sup> 17 CFR 200.30–3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> Securities Exchange Act Release No. 65579 (October 17, 2011), 76 FR 65549 (“Notice”).

<sup>4</sup> See Letter to Elizabeth M. Murphy, Secretary, Commission, from David T. Bellaire, Esq., General Counsel and Director of Government Affairs, Financial Services Institute, dated November 14, 2011 (“FSI Letter”).

when handling an order involving any security, equity or debt, for which there is limited pricing information available.<sup>14</sup>

NASD Rule 3110(b) (Books and Records) generally requires members to indicate on the customer order ticket how they complied with the Three Quote Rule, if applicable. FINRA is proposing to replace this provision with a more general documentation requirement in the Supplementary Material to proposed FINRA Rule 5310. Under that provision, members would be required to retain records sufficient to demonstrate that they had handled orders covered by the rule in accordance with their policies and procedures.

#### (2) Regular and Rigorous Review of Execution Quality

The proposed rule change includes Supplementary Material to proposed FINRA Rule 5310 codifying a member's obligations when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers. These longstanding obligations are set forth and explained in various SEC releases and NASD *Notices to Members*.<sup>15</sup> The proposed rule change codifies this guidance as Supplementary Material and does not alter existing requirements regarding regular and rigorous review.

#### (3) Orders for Foreign Securities for With No U.S. Market

While the determination as to whether a member has satisfied its best execution obligations must take into account the market for a security, NASD Rule 2320, as currently drafted, does not specifically distinguish between orders

for domestic securities and orders for foreign securities, even if there is no U.S. market for the security. The proposed rule change includes new Supplementary Material concerning members' best execution obligations when handling orders for foreign securities, and in particular foreign securities with no U.S. trading activity.

The new Supplementary Material recognizes that markets for different securities can vary dramatically and that the standard of "reasonable diligence" must be assessed by examining specific factors, including "the character of the market for the security" and the "accessibility of the quotation." Accordingly, the determination as to whether a member has satisfied its best execution obligations necessarily involves a "facts and circumstances" analysis.<sup>16</sup>

#### (4) Customer Instructions Regarding the Routing of Orders

When placing an order with a member, customers may specifically instruct the member to route the order to a particular market for execution.<sup>17</sup> The proposed rule change includes Supplementary Material to proposed FINRA Rule 5310 addressing situations where the customer has, on an unsolicited basis, specifically instructed the member to route its order to a particular market.<sup>18</sup> Under those circumstances, the member would not be required to make a best execution determination beyond that specific instruction; however, the Supplementary Material mandates that members process the customer's order promptly and in accordance with the

terms of the order. The Supplementary Material also makes clear that where a customer has directed the member to route an order to another specific broker-dealer that is also a FINRA member, the exception would not apply to the receiving broker-dealer to which the order was directed.<sup>19</sup>

FINRA will announce the implementation date of the proposed rule change in a *Regulatory Notice* to be published no later than 90 days following Commission approval. The implementation date will be no later than 90 days following publication of the *Regulatory Notice* announcing Commission approval.

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,<sup>20</sup> which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>21</sup> The Commission believes that the proposed rule change clarifies the existing best execution requirements, and that these changes enhance investor protection and promote just and equitable principles of trade. The Commission also believes that codifying members' obligations regarding directed orders, regular and rigorous review, and orders involving foreign securities will bring clarification to these areas and ensure that all members are aware of their obligations.

One commenter<sup>22</sup> urged that FINRA provide additional guidance regarding the manner in which a member firm may comply with its best execution obligations with respect to orders for foreign securities with no U.S. market. Specifically, the FSI Letter requests that FINRA amend the Supplementary Material to provide that member firms draft and maintain written policies and procedures regarding foreign securities with no U.S. market that contain certain additional specific elements.<sup>23</sup>

<sup>19</sup> For example, if a customer of Member Firm A directs Member Firm A to route an order to Member Firm B, Member Firm B would continue to have best execution obligations to that customer order received from Member Firm A.

<sup>20</sup> 15 U.S.C. 78o-3(b)(6).

<sup>21</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>22</sup> See FSI Letter, *supra* note 4, at 3.

<sup>23</sup> The commenter specifically requested that the Supplementary Material provide that written policies and procedures regarding foreign securities

<sup>14</sup> See proposed Supplementary Material .06. NASD Rule 2320(f)(2), which is a subparagraph within the Three Quote Rule, generally requires members that display priced quotations on a real-time basis for a non-exchange-listed security in two or more quotation mediums that permit quotation updates on a real-time basis to display the same priced quotation in each medium except for certain customer limit orders displayed on an electronic communications network. Paragraph (f)(4) of the rule includes definitions of terms used in paragraph (f)(2). At this time, FINRA is proposing to move paragraph (f)(2) into the FINRA Rule 6400 Series (Quoting and Trading in OTC Equity Securities) as FINRA Rule 6438. FINRA is also proposing to replace the term "non-exchange-listed security" with the term "OTC Equity Security" to conform the rule language to other FINRA rules addressing non-NMS stocks. The terms "OTC Equity Security" and "quotation medium" are defined in FINRA Rule 6420. Because the provisions relate to the quotation of OTC Equity Securities, FINRA believes that they should be relocated into the FINRA rule series concerning quoting and trading OTC Equity Securities rather than remain part of the Best Execution Rule.

<sup>15</sup> See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); NASD *Notice to Members* 01-22 (April 2001).

<sup>16</sup> The new Supplementary Material notes that even though a foreign security may not trade in the U.S., members still have an obligation to seek best execution for customer orders involving the security. Consequently, a member that handles customer orders for foreign securities that do not trade in the U.S. must have specific written policies and procedures in place regarding its handling of customer orders for these securities that are reasonably designed to obtain the most favorable terms available for the customer, taking into account differences that may exist between U.S. markets and foreign markets. The Supplementary Material further notes that a member's best execution obligations also must evolve as changes occur in the market that may give rise to improved executions, including opportunities to trade at more advantageous prices. Members must therefore regularly review their policies and procedures to assess the quality of executions received and update or revise the policies and procedures as necessary.

<sup>17</sup> When the order is for an NMS security, these orders are often referred to as "directed orders." See 17 CFR 242.600(b)(19).

<sup>18</sup> See proposed Supplementary Material .08. FINRA also has proposed technical amendments to paragraph (e) of the rule to clarify that a member's best execution obligations extend to all customer orders and to avoid the potential misimpression that the paragraph limits the scope of the rule's requirements.

In its response to the comment, FINRA notes that the Supplementary Material as currently drafted already provides that written policies and procedures regarding orders in foreign securities with no U.S. market be “reasonably designed to obtain the most favorable terms available for the customer” and also requires that members “regularly review these policies and procedures to assess the quality of executions received and update or revise the policies and procedures as necessary.”<sup>24</sup> FINRA contends that the commenter’s request for a requirement to provide reasonable notice to customers of a member’s policies and procedures regarding foreign securities with no U.S. market would inappropriately differentiate among a member’s best execution policies and procedures by specifically requiring notification in the context of foreign securities and would be irrelevant to those retail customers that do not trade in foreign securities with no U.S. market.<sup>25</sup> FINRA also argues that a requirement requiring periodic review for compliance with the policies at issue is redundant since, under existing FINRA rules, a member is already responsible for reviewing the conduct of its associated persons for compliance with both its policies and procedures and applicable laws and rules in all aspects of its business.<sup>26</sup> The Commission believes that the proposed rule, and FINRA’s response, respond to the concerns raised by the commenter.

With respect to the proposed deletion of the Three Quote Rule, FINRA has represented that replacing the Three Quote Rule with the proposed Supplementary Material will improve the handling of customer orders involving securities with limited quotation or pricing information by decreasing the likelihood that execution of these orders will be unnecessarily delayed while still ensuring that members recognize that their best execution obligations apply to these orders.<sup>27</sup> The Commission believes that this proposed change will help promote just and equitable principles of trade

with no U.S. market: (1) Are reasonably designed to obtain favorable terms; (2) provide reasonable notice to customers of the policies and procedures; (3) require periodic review for compliance with policies; and (4) require periodic review of the policies themselves to ensure that they meet the requirements of the rule. *See id.*

<sup>24</sup> See FINRA Response to Comment, *supra* note 5, at 2, 3 (citing Supplementary Material .07 to FINRA Rule 5310).

<sup>25</sup> *See id.* at 2.

<sup>26</sup> *See id.* at 3 (citing NASD Rule 3010(b)(1)).

<sup>27</sup> *See* Notice at 65551.

and will protect investors and the public interest.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>28</sup> that the proposed rule change (SR-FINRA-2011-052) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>29</sup>

**Kevin M. O’Neill,**

*Deputy Secretary.*

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-65894; File No. SR-NYSEArca-2011-89]

#### Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Specifying in Its Rules an Existing Policy Related to the Application of NYSE Arca Options Rule 6.47A

December 5, 2011.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that, on November 23, 2011, NYSE Arca, Inc. (the “Exchange” or “NYSE Arca”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed the proposal as a “non-controversial” proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to specify in its rules an existing policy related to the application of NYSE Arca Options Rule 6.47A. The text of the proposed rule change is available at the Exchange, at <http://www.nyse.com>, at the

<sup>28</sup> 15 U.S.C. 78s(b)(2).

<sup>29</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

Commission’s Public Reference Room, and at <http://www.sec.gov>.

#### II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

##### A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

The Exchange proposes to specify in its rules an existing policy related to the application of NYSE Arca Options Rule 6.47A.

NYSE Arca Options Rule 6.47A provides, in part, that Users<sup>5</sup> may not execute as principal orders they represent as agent unless agency orders are first exposed on the Exchange for at least one second. This requirement gives other market participants an opportunity to participate in the execution of orders before the entering User executes them. The Exchange recognizes, however, that because the Exchange does not identify the User that entered an order to the NYSE Arca system, orders from the same OTP Holder or OTP Firm may inadvertently execute against each other as a result of being entered by different persons and/or systems at the same OTP Holder or OTP Firm. Therefore, when enforcing NYSE Arca Options Rule 6.47A, the Exchange does not consider the inadvertent interaction of orders from the same OTP Holder or OTP Firm within one second to be a violation of the exposure requirement.

When investigating potential violations of NYSE Arca Options Rule 6.47A, the Exchange takes into consideration whether orders that executed against each other within one second in the NYSE Arca system were entered by persons, business units and/or systems at the same OTP Holder or OTP Firm that did not have knowledge

<sup>5</sup> The term “User” means any OTP Holder, OTP Firm or Sponsored Participant that is authorized to obtain access to the NYSE Arca system pursuant to NYSE Arca Options Rule 6.2A. *See* NYSE Arca Options 6.1A(a)(19).