SIFMA
Securities Industry and
Financial Markets Association

February 27, 2009

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 08-83: Front Running of Block Transactions

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association[1] ("SIFMA") appreciates the opportunity to comment on Regulatory Notice 08-83, which proposes to amend FINRA's Front Running Policy in NASD Interpretive Material ("IM") 2110-3 ("Front Running Policy"). The proposal would codify the amended Front Running Policy in new Rule 5270 and related Supplementary Material and would significantly broaden the scope of transactions subject to the rule beyond equities, options and security futures to also include other derivatives, financial instruments and financial contracts. Given the significance and scope of the proposed changes, we appreciate that FINRA determined to seek comment from member firms before the proposal is submitted to the Securities and Exchange Commission ("SEC") for public notice and comment.

Before providing our specific comments on proposed Rule 5270 and its Supplementary Material, we have certain fundamental concerns related to the proposed expansion of the Front Running Policy. First, we question the need to extend the application of the Policy beyond trading associated with publicly reported block trades.[2] Historically, front running regulation has been designed to capture instances in which firms inappropriately use material non-public market

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] In commenting on the proposal, this letter refers to "block transactions" or "block trades" in several instances. However, as noted in Section I.C below, SIFMA recommends that FINRA move away from the use of these terms as the threshold for application of the Front Running Policy in favor of a more appropriate threshold of "material transactions" that might vary depending on the characteristics of particular securities.

information[3] concerning an imminent block trade by a customer in a listed security in order to benefit from the market movement likely to result from public dissemination of the transaction. Proposed Rule 5270 covers a much broader range of products and situations than prior front running regulation and appears to introduce a significant amount of subjectivity to the application of the rule, while limiting the ability of firms to use available techniques to provide customers with the best pricing menu for over-the-counter ("OTC") products. In particular, the proposed rule covers instances involving imminent block trades involving a "related financial instrument" that is not publicly reported. Market impact with respect to such OTC transactions is not generally direct and therefore at times not fully observable. There will be a host of practical issues facing firms under the proposed rule related to determining when information regarding a non-reported block trade is "stale and obsolete" such that normal trading operations may recommence without violating the rule. Given these difficulties and their associated regulatory risks on the one hand, and the attenuated opportunity for firms to inappropriately benefit from market impact absent public dissemination of a block transaction, FINRA should limit the application of its Front Running Policy to circumstances in which a block trade involves a publicly reported security.

Second, we also are concerned that broad expansion of the Front Running Policy will have unintended, adverse consequences on the trading of OTC equity derivatives. As you know, broker-dealers, either directly or through an affiliated entity, engaging in OTC equity derivatives transactions largely do so as principal rather than as agent, committing their own capital to such transactions. These transactions involve sophisticated counterparties and are extensively documented using the documentation architecture published by the International Swaps and Derivatives Association ("ISDA"), comprising Master Agreements, standard form confirmations, and definitional booklets. These documents include, among other disclosures, discussions of the capacity of the parties (principal counterparties, not fiduciaries), non-reliance of either party on the other, and agreements and acknowledgements regarding the extent to which hedging may or may not occur in connection with a transaction. ISDA agreements also spell out that each counterparty (and/or its affiliates) may have banking or other commercial relationships with an issuer of securities involved in a transaction and may also engage in proprietary trading in such securities or any related instruments, and that such trading may affect the price of securities that are the subject of the agreement.[4] Thus, today, the OTC equity derivatives market operates well, governed primarily by a disclosure-based regime among sophisticated counterparties.[5]

The proposed Front Running Policy should be modified to preserve the ability of firms and sophisticated counterparties to engage in OTC equity derivatives transactions using this disclosure-based approach. As proposed, Rule 5270 would require a firm engaged in OTC

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[3] As discussed below, with one exception in the proposal, the term "material non-public market information" is used throughout the current and proposed Front Running Policy. To avoid confusion, we believe FINRA should refer to "material non-public *market* information" throughout the rule. *See* Section IV.B.

[4] *See* Section 13.4 of the 2002 ISDA Equity Derivatives Definitions.

[5] We appreciate the recent concerns expressed in the press and by certain regulators and members of Congress regarding oversight of the credit derivatives market. We are not aware, however, of significant problems with respect to front running in OTC equity derivatives.

equity derivatives transactions to demonstrate that other trading at or around the same time of a derivatives transaction was unrelated to material non-public market information received in connection with a counterparty's order, or that the firm was engaged in bona fide hedging unrelated to such information for which the counterparty provided affirmative written consent and under circumstances where an information barrier was in place to prevent the disclosure of such information. As a practical matter, given the scope of trading activities conducted by many firms and the limitations of the hedging exemption, we believe that the proposed rule will cause a significant number of firms to substantially reorganize their operations to impose an unwarranted number of information barriers throughout their organization to accommodate their OTC equity derivatives trading.[6] Alternatively, firms may be less willing to commit capital to such trading. Either result would, in our view, be unfortunate and unwarranted given that the disclosure provided in connection with OTC equity derivatives trades has served both dealers and counterparties well. Proposed Rule 5270 should clearly indicate that trading associated with OTC equity derivative transactions does not violate the rule provided that there is adequate disclosure of the material terms of the transaction between counterparties – including, without limitation, disclosure of any anticipatory, proprietary or other trading that may occur at or around the time of the derivatives transaction.[7] Such an approach would be consistent with other instances in which SROs have recognized the sufficiency of disclosure to customers of a firm's principal trading activities.[8] We note that, pursuant to Rule 2110, FINRA has the ability to address particularly egregious trading – such as intentional misconduct or a pattern of abusive trading by a firm with respect to an account – as inconsistent with just and equitable principles of trade.

Third, we respectfully request that instead of evaluating proposed Rule 5270 in isolation, FINRA should consider this rule in conjunction with analogous NYSE, FINRA and other SRO order handling rules and seek to harmonize the rules where appropriate. For example, FINRA should harmonize common elements of FINRA IM 2110-2 ("Manning Rule"), NYSE Rule 92, and related guidance pertaining to member obligations when handling volume-weighted average priced ("VWAP") and other large orders.[9] Although each of these regulations vary, at their core they are all directed at essentially the same conduct: the obligations of firms to apprise customers of how their orders will be handled and to handle such orders fairly. The rules currently require differing levels of disclosure to or consent from customers,[10] and permit divergent types of

[6] Trading desks that execute OTC equity derivatives on a principal basis with customers and counterparties are the same desks that manage the risk of the firm's overall book of OTC equity derivatives transactions. To comply with the information barriers as drafted in the Supplementary Material would require, in the extreme, an information barrier around each member of the trading desk, which would interfere with effective risk management of the firm's exposures.

[7] As noted, ISDA Master Agreement documentation should suffice for purposes of such disclosure.

[8] *See*, NYSE Information Memo 05-52 (Aug. 1, 2005).

[9] *See*, NYSE Information Memo 05-52 (Aug. 1, 2005) and NASD NTM 05-51 (Aug. 2005).

[10] For example, FINRA interpretive guidance requires an "affirmative consent letter" be delivered on an annual basis in connection with anticipatory hedging of VWAP trades and in connection with blind bid requests, while the NYSE permits a periodic, disclosure-based standard via written notice.

trading by firms.[11] In addition, most of the other SROs have their own front running, trading ahead and hedging regulations similar to those of FINRA, but with some differences.[12] While differing standards may make sense in some instances, such as with respect to how the rule should apply in the context of OTC equity derivatives transactions as discussed above, we believe that the only workable approach, considering the integration of the markets, evolving market structure, cross-asset class trading, and the need to develop well-considered and consistent regulations, is for the SROs to work together to formulate common trading regulations.[13]

In this regard, we recommend that FINRA focus on opportunities to harmonize (i) the knowledge requirement, (ii) permissible hedging and trading activities, (iii) when information is deemed "publicly available," and (iv) disclosure/consent requirements applicable to each regulation. In doing so, FINRA would receive the benefit of more informed comment on the harmonization of these rules by addressing them together rather than singly. Such an approach will result in more efficient and better regulations. We also understand that FINRA plans to discuss the proposed Front Running Policy with members of the Intermarket Surveillance Group ("ISG") and we commend FINRA for these necessary efforts. More frequent consultation of this type often yields greater benefits to SROs, firms and investors.

While we believe that the views noted above regarding fundamental aspects of FINRA's proposal are the most critical to address with any new front running regulations, we recognize that this writing may be our only opportunity to comment on other aspects of the proposed rule prior to FINRA filing the proposal with the SEC. Therefore, the following paragraphs set forth our specific comments on proposed Rule 5270 and its related Supplementary Material.

I. Clarifying the Scope of FINRA's Proposal

A. The Scope of the Proposal Should Be Limited to Equities and Equity-Related Financial Instruments

Proposed Rule 5270 would prohibit member firms and their associated persons from causing the execution, for their own account or for an account for which they exercise investment discretion, of an order to buy or sell *a security* or a related financial instrument when the member or associated person has material non-public market information concerning an imminent block transaction in that *security*, a related financial instrument, or a security

[11] Compare the broader scope of permissible trading by firms that negotiate terms and conditions governing the handling of orders of institutional customers under the Manning Rule with the more narrow and specific trading exceptions set forth in NYSE Rule 92.

[12] *See, e.g.*, NYSE Arca Rule 6.6, CBOE Rule 6.9(e), CBOE Regulatory Circular 99-224 (Dec. 7, 1999), PHLX Rule 1064, PHLX Rule E6, PHLX Rule F6, and ISE Rule 400. We also understand that the CBOE currently is considering a new rule proposal related to hedging stock in connection with options trades.

[13] FINRA has stressed the importance of "not only picking the best of the NASD and NYSE rulebooks, but … also going through a very deliberative process to determine if there might be a better way to address regulatory concerns than simply picking between two existing rules." Mary L. Schapiro, Chairman and CEO, FINRA, Remarks at FINRA Fall Securities Conference, Scottsdale, AZ, Oct. 11, 2007, *available at* http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P037180.

underlying a related financial instrument, prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete. Similarly, members and associated persons would be precluded from buying or selling an underlying *security* when they have material, non-public market information concerning an imminent block transaction in a related financial instrument or a security underlying a related financial instrument, prior to the time that the block transaction has been made publicly available or has otherwise become stale or obsolete.[14]

FINRA's use of the term "security" in the proposal is overly broad and may be read to include fixed income instruments within the scope of the rule. Historically, FINRA's Front Running Policy extended only to equities and equity-based instruments, including options and security futures.[15] We are not aware of any significant regulatory concerns relating to front running of fixed income block orders. These instruments trade and operate in markets different from equity securities. Specifically, fixed income pricing is impacted to a much greater extent by interest rates, credit spreads, a bond's liquidity, and the specific creditworthiness of the issuer.[16] It is unclear whether or the extent to which prior knowledge of an imminent "block" transaction in a fixed income security would permit a firm to predict the effect on the price of the security such that front running regulation is necessary. It also is worth noting that the concept of a block transaction does not translate neatly to the fixed income markets where typical quotation and trading sizes vary by specific fixed income product.[17] While we understand the goal of capturing equity-related instruments under the proposal (including, for example, convertible debt securities), this aspect of the proposed rule also should be limited to instruments related to equity securities. Given the absence of demonstrated front running problems and the differences between the fixed income and equity markets, we do not believe FINRA should extend the Front Running Policy to the fixed income market without a more detailed analysis regarding the need for such a rule and its potential impact on that market.

In this regard, FINRA should modify the proposed rule language and Supplementary Material to focus on equities and equity-related financial instruments by changing "security"

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[14] The proposal also would apply to the accounts of customers provided with material non-public market information concerning an imminent block transaction.

[15] *See, e.g.*, NASD Regulatory and Compliance Alert Vol. 10, No. 3 (Fall 1996) (in the context of NASD's decision to hold off applying its front-running policy to government securities, describing its front running interpretation as designed to apply to equity securities); NASD NTM 96-66 (Oct. 1996) (temporarily excepting the application of IM-2110-3 to government securities because IM-2110-3 "applies, by its terms, only to equity securities").

[16] *See, e.g.*, Roger D. Blanc, Wilkie Farr & Gallagher, Exemption From, and Temporary No-Action Position Under, the Order Execution Rules for Trading in Preferred Securities (Jul. 31, 1997); Exchange Act Rel. No. 38067 (Dec. 20, 1996) (adopting an exception to Rule 101 of Regulation M for certain nonconvertible debt securities); Exchange Act Rel. No. 57621 (Apr. 4, 2008) (distinguishing fixed income instruments and non-convertible preferred stock from equity and excluding the former from Rule 611(a)).

[17] For instance, a round lot in high grade fixed income securities generally may range from $2 million - $5 million, whereas a round lot in high yield fixed income securities generally is viewed as between $1 million - $2 million.

references to "equity security" and changing "related financial instrument" to "financial instrument related to an equity security."[18]

B. Determining the Scope of Related Financial Instruments

In addition to appropriately limiting the proposed rule to those financial instruments that are related to equity securities, FINRA should publish guidance regarding certain instruments that may present particular challenges in determining whether they are related to an underlying security. Although language in the proposing release indicating that a related financial instrument, in essence, means a security that is materially related to a security, acts as a substitute for a security, or is the functional equivalent of a position in a security will be helpful in most instances, basket and index transactions may, for example, present just such challenges. In this regard, we note that other SROs have provided more objective standards for assessing when an index or basket is related to an underlying security. For example, CBOE, as well as other SROs, apply a ten percent test to orders involving component securities when analyzing whether such trades are related to an order to buy or sell an index or basket.[19] FINRA should adopt a more objective standard, such as a percentage or number of names in a basket or program, as a rebuttable presumption that an instrument is related to the underlying security while allowing firms to demonstrate by a reasonable methodology whether an instrument is or is not related to the underlying security.[20]

Some instruments, although marginally linked to equity securities, are sufficiently complex that it will be virtually impossible to determine whether they will constitute a related security, and if so, whether trades involving them meet the threshold for application of the rule. For example, variance swaps and volatility swaps fall into this category.[21] Given the difficulty in assessing whether they are related financial instruments and the possibility that such trades could occur while a firm also is separately trading in an associated equity security, we recommend that FINRA exclude these instruments from the scope of the rule.

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[18] As noted above, the proposed Front Running Policy should be limited to transactions involving publicly reported block trades.

[19] *See, e.g.*, CBOE Rule 6.9(e) ("… a "related instrument," means, in reference to an index option, an order to buy or sell securities comprising ten percent or more of the component securities in the index or an order to buy or sell a futures contract on any economically equivalent index"); *see also*, PHLX Rule 1064(d), NYSE Arca Rule 6.49, and AMEX Rule 950.

[20] We note that the difficulty faced by firms in tracking for overlap between single asset and basket or index transactions has been previously considered and ultimately addressed through use of information barriers. *See*, NYSE Information Memo 01-21 (Aug. 9, 2001) (discussing the use of information barriers with respect to program trading). This historical treatment highlights the challenges of establishing and implementing standards for effective surveillance. We would ask FINRA to consider exempting these types of transactions to the extent they are managed as part of principal-based, capital commitment trading operations.

[21] For example, a variance swap allows one to speculate or hedge based on the volatility of an underlying product.

C. FINRA Should Create a New Standard to More Effectively Capture Trades that Have the Potential to Move the Market

As part of its comprehensive reexamination of its trading rules, the use of "block transaction" as the threshold for identifying transactions subject to the Front Running Policy should be revisited by FINRA. As currently defined in NASD IM 2110-3, a "block transaction" includes a transaction involving 10,000 shares or more of an underlying security, or options or security futures covering such number of shares (although a transaction of less than 10,000 shares could be considered a block transaction in appropriate cases).[22] The Supplementary Material to the proposed rule would expand this definition by substituting "related financial instruments" for options and securities futures.[23]

Notwithstanding its prior utility, we believe that the definition of a block transaction no longer effectively captures the types of transactions that the Front Running Policy is designed to address. For example, it is not at all clear that a 10,000 share order will have much impact on the market for a particularly active equity security. By contrast, a much smaller trade could have substantial impact on the market for a less active stock. Given the expansive nature of the proposed rule, we believe FINRA should focus the rule on "material transactions" rather than block trades. A material transaction might be defined in any number of ways. For example, FINRA could establish threshold sizes for material transactions that vary based on whether the publicly reported transaction involves a large cap, mid cap or small cap security. Alternatively, threshold sizes for different securities might be tied to indices with which they may be associated (*e.g.*, S&P 500, Russell 2000). FINRA might also consider simply increasing the threshold for a material transaction (*e.g.*, 100,000 shares) while permitting firms flexibility to rebut this presumption by showing that an ostensibly material transaction in fact had no impact on the market (such as by focusing on the average daily trading volume or absence of price movement for a security). SIFMA would be pleased to work with FINRA to establish an appropriate threshold for application of the Front Running Policy.

D. FINRA's Proposal Should Confirm the Scope of the Term Customer

The proposed rule contains several exceptions related to facilitating a customer order. The term "customer" is not defined in the proposed rule, but is defined in NASD Rule 0120(g) as a non broker or dealer. With respect to OTC derivatives, dealers are often organized as banks, bank branches of foreign banks, or unregistered affiliates of broker-dealers. In light of their sophistication and market making role, FINRA should clarify that, for purposes of the proposed rule, such unregistered counterparties do not qualify as a "customer."

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[22] NASD Rule IM-2110-3. We also note that "blocks" are defined somewhat differently in other rules. *See, e.g.,* NYSE Rule 127 (defining a block as at least 10,000 shares or a quantity of stock having a market value of $200,000 or more, whichever is less, which is acquired by a member organization on its own behalf and/or for others from one or more buyers in a single transaction).

[23] FINRA Regulatory Notice 08-83, Supplementary Material .03 (Dec. 2008).

II. Application of the Proposal to Non-Reportable Instruments -- The Stale and Obsolete Standard is Too Subjective

FINRA's current Front Running Policy is limited to securities transactions reported via last sale reporting systems.[24] Proposed Rule 5270 also would apply to related financial instruments that may not result in publicly reported trades. The proposed rule provides that trading prohibitions related to such instruments are to remain in place until the relevant material non-public information becomes "stale or obsolete."

For the reasons discussed at the outset of this letter, we strongly believe FINRA should limit the Front Running Policy to transactions involving block trades of publicly reported instruments. Such an approach would eliminate much of the difficulty associated with the proposed Front Running Policy while preserving the traditional prophylactic focus of the rule. Absent this, SIFMA is concerned that the subjectivity that inevitably will be involved in determining when information regarding an instrument that is not subject to public trade reporting becomes "stale or obsolete" will result in many unwarranted regulatory inquiries, examination findings and, perhaps, enforcement actions. Although NTM 05-51 uses a similar standard in describing a firm's duty to refrain from trading prior to the receipt of an order when a firm is involved in the negotiation of certain orders,[25] in practice, much of this guidance has been applied in the context of VWAP and other orders involving equity securities where the transaction will be publicly reported. Firms have adopted policies and procedures to govern instances where, for example, they may have provided a blind bid to a customer upon request but did not receive the business. However, the latter situations occur fairly infrequently relative to VWAP facilitation activities. We are concerned that the proposal to include a broader universe of related instruments that are not publicly trade reported in the Front Running Policy will only increase the number of judgments necessary to determine when information becomes stale or obsolete.

SIFMA would be pleased to work with FINRA to develop more guidance on when material non-public information that is not ultimately publicly reported becomes stale or obsolete. However, without further guidance it will be particularly important for FINRA examiners to recognize the subjectivity and lack of a uniform standard in this area and to focus their examinations on a firm's policies and procedures in this area. FINRA historically has pursued front running related enforcement actions against firms where there has been a clear misuse of information in an attempt to move the market and benefit from such information.[26] In light of the subjectivity in the proposed rule, it will become even more important for FINRA to apply its resources to pursuing clear violations of the Front Running Policy.

[24] NASD IM-2110-3; *see also*, Notice to Members 87-69 (Oct. 1987).

[25] NASD Notice to Members 05-51 (Aug. 2005).

[26] *See, e.g., Department of Enforcement vs. Jericho Nicolas, Angel Cruz and Anthony Joseph Martinez*, CAF040052 (Mar. 12, 2008).

III. Knowledge Standard in Supplementary Material .01

A. Confirm that the Knowledge Standard is the Same as that in NTM 05-51

Notwithstanding differences in language, it is our understanding that the knowledge standard in Supplementary Material .01 is intended to be applied in the same manner as that in NTM 05-51. Supplementary Material .01 states that a duty to refrain from trading may attach upon knowledge of less than all terms of the transaction so long as there is knowledge that all the material terms of the transactions have been or will be agreed upon imminently. NTM 05-51 interprets the duty to refrain from trading as applying when a firm receives specifics of a transaction "to a degree of confidence whereby the [firm] can engage without undue speculative risk in targeted hedging or positioning activity…" We respectfully request that FINRA clarify the appropriate interpretation and scope of the knowledge standard in its proposal.

B. Knowledge Standard: Block Orders for Both an Option and an Underlying Security

FINRA's current Front Running Policy provides an exception from the knowledge standard (and, consequently, from the prohibitions of the rule) for situations when a member receives a customer order of block size relating to both an option and an underlying security or both a security future and an underlying security.[27] In its proposal, FINRA deleted these exceptions. We understand that these trades have never presented regulatory concerns and request that FINRA confirm that such transactions will continue to be permissible under the proposed rule.[28]

IV. Permissible Transactions

A. Generally

Like the current Front Running Policy, Supplementary Material .04 to the proposed rule excludes certain transactions from the front running prohibition, including: (i) transactions related to a prior customer order; (ii) "black box" orders where the member has no actual knowledge that the customer order has been routed for execution; (iii) trades to correct bona fide errors; and (iv) off-lot transactions to offset odd-lot orders. Additionally, an exception exists for bona fide hedging that requires a firm to demonstrate that the trading was unrelated to material non-public information related to the customer order <u>and</u> was subject to an information barrier.

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[27] NASD IM-2110-3(b).

[28] It may be the case that Supplementary Material .04, which permits trading activity where the member can demonstrate it is unrelated to the material non-public information received in connection with the customer order includes trading in connection with orders involving an option and the underlying security. Nonetheless, we believe it is useful to clarify the permissibility of these transactions under the proposed rule. As noted previously and below in Section IV.B, FINRA should conform the references to "material non-public information" in Supplementary Material .04 to "material non-public market information," as used in the current rule and in the rest of the proposed rule.

As noted above, FINRA should first clarify that the proposed rule change is not meant to modify the manner in which firms conduct their OTC equity derivatives business – namely, through the disclosures and agreements set forth in ISDA agreements with sophisticated counter-parties. We also believe the list of permissible activities in the proposed rule may be simplified. Specifically, any one or more of the following transactions should be permitted under the proposed Front Running Policy:

1. Transactions unrelated to material, non-public market information related to the customer order;

2. Transactions that were subject to an information barrier;

3. Transactions where a customer receives written notice about a firm's hedging activity;[29]

4. Transactions related to a prior customer order;

5. Transactions involving "black box" orders;

6. Riskless principal transactions;

7. Facilitation transactions;

8. Bona fide error corrections; or

9. Odd-lot transactions.

We note that, as currently drafted, the first two exceptions of the proposal would permit trading unrelated to material non-public market information only where there also is an information barrier and vice versa. Thus, the proposal will mandate the use of information barriers in situations where they are unnecessary. We believe that the existence of an information barrier obviates the need to also show that information is also unrelated to material non-public market information. FINRA should clarify the proposed rule to permit either transaction.

B. Material Non-Public Market Information

Like current IM 2110-3, proposed Rule 5270 prohibits front running when a firm has "material non-public market information" concerning an imminent block transaction. However, proposed Supplementary Material .04 provides an exception from the prohibition of the rule where a firm can demonstrate that its trading is unrelated to the "material non-public information" received in connection with a customer order, or where a firm can show, among other things, that a hedge is unrelated to "material non-public information" in connection with a customer order. Because both terms, in this context, are meant to apply to information related to

[29] The requirement to provide written notice should not apply where the terms of a customer order implicitly convey the customer's consent to a firm's hedging activity (*e.g.*, a customer "stop order").

the relevant block transaction, and since "material non-public information" is used in a variety of other, unrelated contexts throughout the federal securities laws, FINRA should conform references in the Supplementary Material to language describing "material non-public market information" in the current and proposed rule to avoid any potential for confusion.

C. FINRA's Proposal Should Define Black Box Orders

As discussed above, an exception from the trading prohibitions of the Front Running Policy exists for black box orders. This term is undefined in the proposed rule and we suggest that the term "black box orders" include orders entered either by the customer, firm or its associated person into a computerized facility that will at periodic intervals during the trading day send a portion of the overall order, without intervention by the firm or its associated persons, for execution.[30] If the firm does not have actual knowledge that, in fact, a portion of the order has been sent for execution, the firm may enter proprietary orders in the same security without being deemed in violation of FINRA's proposal.

V. Consent Standard: FINRA Proposal Should Permit Written Disclosure in Connection with Hedging Activities Consistent with NYSE Information Memo 05-52

Proposed Supplementary Material .04 would require a customer's affirmative written consent to engage in positioning or hedging activity. FINRA and the NYSE have issued different guidance regarding a firm's disclosure obligations to its customers when it engages in anticipatory hedging and other positioning activity.[31] Specifically, FINRA requires that a member firm disclose in writing to a customer, prior to receipt and/or execution of a VWAP or other large order, that it intends to engage in hedging or other positioning activity related to the handling of the order.[32] This disclosure must be in the form of affirmative written consent and firms are required to have customers reaffirm their consent at least annually. Alternatively, NYSE Information Memo 05-52 requires similar disclosure but permits firms to deliver written disclosure to a customer prior to receipt and/or execution of the order without requiring affirmative written consent.

More than three years have passed since FINRA and NYSE issued this interpretive guidance and established these disclosure regimes. We are unaware of information that suggests the affirmative written notice required by the NYSE has resulted in any less customer protection than FINRA's approach. Moreover, NYSE's approach is easier for firms to control and implement and provides direct disclosure to customers without the administrative burden of ensuring that customers return a response. Therefore, we recommend that FINRA adopt a written notice standard for consent to trading activities performed by the firm and allow firms to reasonably tailor such disclosures to their business and practices.

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[30] Firms should be permitted, consistent with this definition, to cancel or modify the terms of an order at a customer's request.

[31] *See* NASD Notice to Members 05-51 (Aug. 2005); NYSE Information Memo 05-52 (Aug. 2005).

[32] *Id*.

We do believe, however, that there may be value to FINRA providing additional guidance on the type of disclosure contemplated by the rule through the publication of sample disclosure. We stand ready to work with FINRA to craft sample guidance or an industry-wide standard disclosure that would help avoid customer confusion in this area.

Finally, the ongoing trading obligations of members that obtain customer consent to hedging and other positioning activity is somewhat unclear under Supplementary Material .04. Specifically, the Supplementary Material notes that firms obtaining customer consent "must still refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interest ahead of those of its customer."[33] By contrast, in discussing the obligations of firms engaged in such activities, NASD NTM 05-51 indicates that members receiving customer orders are obligated to (1) refrain from conduct that could disadvantage or harm the execution of a customer's order, and (2) if applicable, disclose in writing to the client that the firm's hedging activities could affect the market for the security. Any hedging associated with a large order has the potential to impact the market for the underlying security and, thereby, "disadvantage" or "harm" the execution of a customer's order. Given that firms engaged in this practice are required to disclose this possibility to their customers, we suggest that FINRA clarify that the admonition against any further harm to the customer in such circumstances is meant to apply to conduct or actions that a firm should have reasonably known would cause extreme market impact or is substantially unrelated to the risks it incurred by entering into the transaction and which, thereby, severely disadvantages or harms the execution of the customer's order.

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We appreciate the opportunity to provide comment on FINRA's proposed modifications to the Front Running Policy. SIFMA would be pleased to discuss any comments herein, or provide FINRA with any additional assistance as it proceeds with the rule proposal. Please do not hesitate to contact us at 202-962-7300 or 212-313-1000 if you have any questions.

Sincerely,

Ann Vlcek
Managing Director and Associate General Counsel

/s/ Gerard J. Quinn
Gerard J. Quinn
Managing Director and Associate General Counsel

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[33] Regulatory Notice 08-83, Supplementary Material .04.