Financial Industry Regulatory Authority

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August 9, 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2012-026 — Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing, a proposed rule change to amend FINRA's rules regarding the handling of stop orders."[1] The SEC issued the proposed rule change for notice and comment on May 31, 2012 and received four comment letters.[2]

Three commenters generally supported the objective of providing members with flexibility to use an event other than a transaction at the stop price to trigger a stop order, but believed that this flexibility should be permitted without the use of a new order type.[3] For example, TD Ameritrade argued that it is unnecessary to require a new order type because quotation-based stop orders have not been identified as problematic or misunderstood by investors. SIFMA similarly argued that the costs and burdens of creating a new order type to use non-transaction-based triggers would outweigh any

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1 *See* Securities Exchange Act Release No. 67085 (May 31, 2012), 77 FR 33537 (June 6, 2012) (File No. SR-FINRA-2012-026; Notice of Filing of Proposed Rule Change Relating to the Handling of Stop and Stop Limit Orders) ("Notice").

2 *See* letter from KOR Trading LLC., dated July 9, 2012 ("KOR"); letter from Virgil F. Liptak, dated July 3, 2012 ("Liptak"); letter from TD Ameritrade, dated June 27, 2012 ("TD Ameritrade") and letter from Securities Industry and Financial Markets Association, dated June 26, 2012 ("SIFMA").

3 *See* TD Ameritrade; *see also* SIFMA and KOR. SIFMA stated that, while some members preferred flexibility, others preferred one established trigger point.

benefits and likely would cause confusion among investors, thereby impairing the appropriate handling of their orders.[4]

These commenters generally asserted that requiring the industry to create a quotation-based stop order type would impose additional technology and other implementation costs without clearly defined benefits. SIFMA instead advocated for the use of a negative consent and disclosure approach for informing investors of the applicable triggering event for a stop order. KOR advocated for an affirmative consent regime.

As described in the rule filing, Rule 6140(h) currently provides that a member may, but is not obligated to, accept stop orders in a security. Rule 6140(h) further provides that, to the extent a member does accept a stop order, the trigger for activating a stop order as a market order (or a stop limit order as a limit order) occurs when a transaction takes place at the stop price.[5] The purpose of the proposed rule change is to make explicit in FINRA rules that, notwithstanding the existing requirement in Rule 6140(h) that firms use transactions as the trigger for stop orders, firms are permitted – but not required – to offer additional order types using other triggers such as quotations. In this regard, the proposed rule change clarifies that if a member chooses to offer an order type with an alternative trigger, such order type must be clearly differentiated from trade-triggered stop orders.

Throughout the rulemaking process for this proposal, FINRA received significant input from members regarding alternative approaches to formulating rules on the handling of stop orders. As discussed in the Notice, FINRA originally proposed deleting the current requirement altogether, which would have had the effect of permitting members to choose the trigger for stop orders.[6] However, the SEC disapproved that

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4 *See also* KOR.

5 Stop buy orders generally are entered by investors with short positions to limit losses should the stock price increase. Stop sell orders generally are entered in a stock whose price has increased substantially in order to protect the investor's profits should the stock price decline. An analysis of orders reported to OATS by FINRA members during the month of June 2012 revealed that stop and stop limit orders accounted for only 0.0235% of all order types.

6 *See* Exchange Act Release No. 63256 (November 5, 2010), 75 FR 69503 (November 12, 2010) (File No. SR-FINRA-2010-055; Notice of Filing of Proposed Rule Change to Amend FINRA Rule 6140) ("Original Proposal").

proposal citing, among other things, the concern that FINRA rules do not explicitly require members to disclose what event would serve as the trigger for stop orders.[7]

Following disapproval of the Original Proposal, FINRA engaged in extensive discussions with members and received a wide range of views, which FINRA fully considered in formulating the instant proposal. For example, FINRA considered removing the current definition of "stop order" and substituting a disclosure provision that would require members to disclose to customers how stop orders would be triggered (as discussed by the SEC in its Disapproval Order). However, members voiced strong concerns that this approach would be problematic because, among other things, investors would be confused as to how their stop orders would be handled if different members could use different triggers for the same order type, and errors could arise if the order were executed through another broker with a differing trigger for the stop order.

Some members expressed the more general concern that quotation-triggered stop orders could result in the activation of a stop order at a price at which the stock had not traded that day, confusing investors and, particularly in thinly traded securities, making investors more vulnerable to abuse because quotes can be more easily manipulated to trigger stops. A subgroup of these members recommended that FINRA mandate that all firms offer stop orders that use transactions as the triggering event because they believed they are less susceptible to abuse.

In contrast, some members noted that the use of transactions as a trigger for stop orders can be problematic because trades outside the current market, whether permissible transactions or clearly erroneous trades, could improperly trigger stop orders. Further, some members noted that, for thinly traded securities (*e.g.*, certain exchange-traded funds), while limited trading may occur during the trading day, quotations are updated continuously and serve as a better indicator of current market price. These members argued that, in light of the concerns regarding using transactions in some securities, firms

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7 ". . . the Commission believes that, if FINRA rules were to permit members flexibility in the types of stop orders they offer, those rules should clearly require, at a minimum, that the member disclose to customers the type of stop order it offers. The Commission believes the regulatory framework should promote the ability of investors to understand the key attributes of order types offered by their brokers so that they can make an informed choice as to whether to use a particular type of order. This is especially true with more complex order types, such as stop loss orders, and particularly if FINRA rules permit a variety of stop loss orders to be offered."

See Exchange Act Release No. 63885 (February 10, 2011), 76 FR 9062 (February 16, 2011) (File No. SR-FINRA-2010-055; Order Disapproving Proposed Rule Change To Amend FINRA Rule 6140) ("Disapproval Order").

should be provided the flexibility to determine which, if any, order types are offered by the firm.

FINRA's proposal takes into account the extensive and informative input that members provided throughout the rulemaking process. FINRA considered retaining the existing rule to require that only transactions could be used as the basis for stop orders. FINRA also considered not establishing a default for the trigger for stop orders. FINRA believes that the default trigger with the availability of other triggers as part of other order types strikes the appropriate balance in addressing the concerns raised by members, including regarding potential investor confusion, manipulation of stop orders and permitting firms flexibility in offering various order types. FINRA also does not believe the proposed rule change would impose additional costs on members continuing existing practices, given that the current rule already requires that orders labeled as "stop" and "stop limit" use a transaction-based trigger, thus requiring order types using other triggers to be labeled differently.

FINRA is concerned that permitting stop order triggers to vary solely based on customer consent, as suggested by certain commenters, while perhaps imposing less upfront costs on firms, would result in less uniformity across firms and may diminish the level of certainty for customers as to how their stop orders will be treated (as noted throughout the process by other members). As such, FINRA believes the proposed rule change effectively addresses the concerns previously raised by the SEC and that continue to be raised by members relating to the potential for investor confusion with respect to the operation of stop orders, while providing all members with the flexibility to offer order types based on a variety of triggers.[8]

Finally, the Notice provides that FINRA will implement the proposed amendments within 150 days of SEC approval. FINRA will provide an implementation period of no less than 90 days following SEC approval to allow for technology changes should members determine to offer alternative order types to customers.

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FINRA believes that the foregoing responds to the material issues raised in the comment letters to this rule filing. If you have any questions, please contact me at (202) 728-8363.

Sincerely,

Racquel L. Russell
Assistant General Counsel

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8 *See* Disapproval Order.