

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67778; File No. SR-FINRA-2012-026)

September 4, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Relating to the Handling of Stop and Stop Limit Orders

I. Introduction

On May 24, 2012, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend FINRA’s rules relating to the handling of stop orders and stop limit orders. The proposed rule change was published for comment in the Federal Register on June 6, 2012.³ The Commission received four comment letters regarding the proposal.⁴ On July 19, 2012, the Commission designated a longer period to act on the proposed rule change, until September 4, 2012.⁵ On August 9, 2012, FINRA submitted a response to the comment letters.⁶ This order approves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67085 (May 31, 2012), 77 FR 33537 (“Notice”).

⁴ See Letters to Elizabeth M. Murphy, Secretary, Commission, from Ann L. Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated June 26, 2012 (“SIFMA Letter”); Gary J. Sjostedt, Director, Order Routing and Sales, TD Ameritrade, Inc., dated June 27, 2012 (“TD Ameritrade Letter”); and Christopher Nagy, President, KOR Trading LLC, dated July 9, 2012 (“KOR Letter”); and web comment from Virgil F. Liptak, dated July 3, 2012 (“Liptak Letter”). The comment letters received by the Commission are available at <http://www.sec.gov/comments/sr-finra-2012-026/finra2012026.shtml>.

⁵ Securities Exchange Act Release No. 67471, 77 FR 43620 (July 25, 2012).

⁶ See Letter to Elizabeth M. Murphy, Secretary, Commission, from Racquel L. Russell, Assistant General Counsel, Regulatory Policy and Oversight, FINRA, dated August 9, 2012 (“FINRA Response”).

II. Description of the Proposal

FINRA proposes to amend its rules governing the handling of stop orders. FINRA Rule 6140(h) currently provides that a member may, but is not obligated to, accept a stop order or a stop limit order in a designated security.⁷ A buy stop order becomes a market order when a transaction takes place at or above the stop price, and a sell stop order becomes a market order when a transaction takes place at or below the stop price.⁸ When a transaction occurs at the stop price, a stop limit order to buy or sell becomes a limit order at the limit price.⁹ Accordingly, FINRA rules provide that stop orders and stop limit orders are triggered (i.e., become a market or a limit order) by a transaction in a security.

FINRA now proposes to also allow members to offer customers stop orders and stop limit orders that would be triggered by a transaction or by an event other than a transaction (e.g., a quotation).¹⁰ FINRA has indicated that some firms and their customers prefer alternative triggers for activating stop orders and stop limit orders.¹¹ According to FINRA, some members believe that, for certain securities, quotations may serve as a better indicator of the current price than transactions.¹² For example, quotations for thinly traded securities may be continuously

⁷ FINRA Rule 6140(a) defines a “designated security” as any NMS stock as defined in Rule 600(b)(47) of Regulation NMS, 17 CFR 242.600(b)(47).

⁸ See FINRA Rule 6140(h)(1)(A)–(B).

⁹ See FINRA Rule 6140(h)(2).

¹⁰ FINRA previously proposed to delete in its entirety Rule 6140(h). See Securities Exchange Act Release No. 63256 (November 5, 2010), 75 FR 69503 (November 12, 2010) (SR-FINRA-2010-055). The Commission disapproved that proposed rule change. See Securities Exchange Act Release No. 63885 (February 10, 2011), 76 FR 9062 (February 16, 2011) (Order Disapproving SR-FINRA-2010-055).

¹¹ See Notice, supra note 3, at 33537.

¹² See id.

updated, whereas there may be limited trading in the securities.¹³ However, FINRA also states that some members and customers prefer to have transactions trigger stop orders and stop limit orders, and believe that customers could be disadvantaged if quotations trigger stop orders and stop limit orders.¹⁴ For example, some members are concerned that using quotations as a trigger could result in an execution at a price that the stock had never traded at on that day.¹⁵

FINRA proposes permitting a member to accept an order type that activates as a market or limit order using an event other than a transaction at the stop price as the trigger, such as a quotation.¹⁶ The member may not label the order type a “stop order” or a “stop limit order,” and must clearly distinguish it from a “stop order” and a “stop limit order.”¹⁷ For example, an order type that triggers using a quotation at the stop price may be labeled a “stop quotation order.”¹⁸ FINRA believes that requiring members to distinguish orders triggered by an event other than a transaction from stop orders or stop limit orders will allow members and customers to share a uniform understanding that transactions serve as the triggering event for stop orders and stop limit orders.¹⁹ In addition, FINRA proposes that the member offering such an order type must

¹³ See id.

¹⁴ See id.

¹⁵ See id. FINRA states that some members expressed concern that quotations may be more vulnerable to abuse because they can be manipulated to trigger stops and then withdrawn or changed, while other members noted that using transactions also could result in the improper triggering of a customer’s stop order due to trades at prices outside of the current market. See id. at 33537 n.6.

¹⁶ FINRA proposes to move the stop order definition from FINRA Rule 6140(h) to proposed FINRA Rule 5350. FINRA states that this will ensure that the existing and proposed stop order provisions apply uniformly to both OTC Equity Securities and NMS stocks. See id. at 33538.

¹⁷ See Proposed FINRA Rule 5350, Supplementary Material .01.

¹⁸ See Notice, supra note 3, at 33538.

¹⁹ See id.

disclose to the customer, in paper or electronic form, prior to the time the customer places the order, a description of the order type including the triggering event.²⁰ A member that permits customers to engage in securities transactions online must also post the required disclosures on the member's website in a clear and conspicuous manner.²¹

FINRA further proposes that a member that routes a customer stop order or stop limit order to another broker-dealer or exchange for handling or execution must take reasonable steps to ensure that the order is handled or executed by the other broker-dealer or exchange in accordance with proposed Rule 5350(a).²² Similarly, under the proposal, a member that routes an order type using an alternative trigger (i.e., a trigger other than a transaction) to another broker-dealer or exchange must take reasonable steps to ensure that the order is handled or executed by the other broker-dealer or exchange in accordance with the terms of the order as communicated to the customer placing the order.²³

FINRA believes that, given the various risks and benefits of each triggering event, members and their customers should determine the appropriate triggering event for stop orders and stop limit orders.²⁴ In addition, FINRA believes that providing customers and members with the flexibility to select and offer other triggering events for alternative order types in accordance with their investment objectives and business models, while requiring members to disclose a

²⁰ See Proposed FINRA Rule 5350, Supplementary Material .01. For example, the disclosure can be made at account opening. See Notice, supra note 3, at 33538.

²¹ See Proposed FINRA Rule 5350, Supplementary Material .01.

²² See Proposed FINRA Rule 5350, Supplementary Material .02.

²³ See id.

²⁴ See Notice, supra note 3, at 33538.

description of the order type, including the triggering event, prior to the time the customer places the order, will promote just and equitable principles of trade.²⁵

III. Summary of Comments Received and FINRA’s Response

The Commission received four comment letters on the proposed rule change.²⁶ KOR Trading LLC (“KOR”), the Securities Industry and Financial Markets Association (“SIFMA”), and TD Ameritrade, Inc. (“TD Ameritrade”) generally supported FINRA’s objective to provide members with flexibility regarding the triggers for stop orders, but preferred a disclosure-based approach over creation of a new order type.²⁷ An individual commenter believes that FINRA should retain and enforce Rule 6140(h) as written rather than amend it to accommodate members that were offering stop orders and stop limit orders triggered by events other than a transaction and disclosing the triggering event in brokerage agreements.²⁸

KOR stated that the use of disclosures, especially those requiring affirmative consent, would allow investors flexibility to choose the trigger for stop orders and stop limit orders, and would reduce the burden on the industry to create new order types.²⁹ KOR also stated that brokers should increase efforts to educate their customers about stop orders and stop limit orders.³⁰

SIFMA stated that, although some of its members would like flexibility in choosing the applicable trigger for stop orders and stop limit orders and others would prefer to have one established trigger point, SIFMA members agree that FINRA should not introduce a new order

²⁵ See id.

²⁶ See supra note 4.

²⁷ See KOR Letter; TD Ameritrade Letter; SIFMA Letter.

²⁸ See Liptak Letter.

²⁹ See KOR Letter.

³⁰ See id.

type to provide for the desired flexibility.³¹ Instead, SIFMA advocates a disclosure and negative consent approach in which a firm would be required to disclose what would trigger a stop order or stop limit order and, if the customer does not object to the disclosed trigger, the firm may conclude the customer consents to the use of that trigger.³² SIFMA believes this approach would avoid the costs and burdens of creating a new order type, including the cost of educating investors about the new order type.³³

TD Ameritrade raised concerns that FINRA's proposal would create an undue burden on the industry by requiring it to incorporate a new order type without clearly defined benefits, and may create unnecessary investor confusion.³⁴ In addition, TD Ameritrade believes creating a new order type identifying stop orders and stop limit orders triggered by a quotation is unnecessary as there is no evidence investors misunderstand or are harmed by such orders.³⁵

FINRA responds that the proposed rule change addresses concerns related to the potential for investor confusion with respect to the operation of stop orders and stop limit orders, while providing members the flexibility to offer orders types based on other triggers.³⁶ FINRA notes that it has engaged in extensive discussions with its member firms about the proposed rule change and has taken into account the input provided by members in formulating the proposed rule change.³⁷ For example, FINRA had considered removing the current definition of "stop order" and substituting a disclosure provision that would require members to disclose to

³¹ See SIFMA Letter.

³² See id.

³³ See id.

³⁴ See TD Ameritrade Letter.

³⁵ See id.

³⁶ See FINRA Response at 4.

³⁷ See id. at 3.

customers how stop orders would be triggered.³⁸ FINRA states that its members expressed a number of concerns about this approach, including that it could lead to investor confusion regarding the handling of stop orders, errors when routing stop orders for execution to another broker that uses a different trigger for stop orders, and executions of quotation-triggered stop orders at prices at which the stock had not traded that day.³⁹ FINRA also had considered retaining the existing rule to require that only transactions trigger stop orders and stop limit orders.⁴⁰ However, certain FINRA members were concerned that trades outside the current market, whether permissible transactions or clearly erroneous trades, could improperly trigger transaction-based stop orders and stop limit orders, and believed that quotations may serve as a better indicator of current market price for thinly traded securities.⁴¹

FINRA believes the proposed approach—to retain the default trigger while permitting the use of other triggers and requiring disclosure of those triggers—strikes the appropriate balance in addressing the views expressed by FINRA members.⁴² In particular, FINRA believes that the proposal would provide members with flexibility in offering various order types, while also addressing concerns regarding the potential for investor confusion with respect to the operation of stop orders.⁴³

FINRA states that the purpose of the proposed rule change is to make explicit in FINRA rules that firms are permitted to offer stop orders and stop limit orders that are triggered by an event other than a transaction, such as a quotation, as long as that order type is clearly

³⁸ See id.

³⁹ See id.

⁴⁰ See id. at 4.

⁴¹ See id. at 3.

⁴² See id. at 4.

⁴³ See id.

differentiated from stop orders and stop limit orders triggered by a transaction.⁴⁴ Contrary to views expressed by commenters, FINRA does not believe the proposed rule change would impose additional costs on members that offer stop orders and stop limit orders given the current requirement to use a transaction-based trigger for orders labeled as “stop” or “stop limit,” thus requiring order types that use an alternative trigger to be labeled differently.⁴⁵ In addition, FINRA is concerned that allowing the trigger for stop orders and stop limit orders to vary solely based on customer consent may diminish the level of certainty for customers as to how stop orders would be treated and would result in less uniformity in the handling of stop orders and stop limit orders.⁴⁶

IV. Discussion and Commission’s Findings

After careful review of the proposed rule change, the comment letters received, and FINRA’s response, the Commission finds that the proposed rule change is consistent with the requirements of Section 15A(b) of the Act⁴⁷ and the rules and regulations thereunder applicable to a national securities association.⁴⁸ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,⁴⁹ which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to

⁴⁴ See id. at 2.

⁴⁵ See id. at 4.

⁴⁶ See id. Finally, FINRA notes that it will provide an implementation period of no less than 90 days following Commission approval of the proposed rule change to provide members that determine to offer stop orders and stop limit orders with alternative triggers with time to make necessary technology changes. See id.

⁴⁷ 15 U.S.C. 78o-3(b).

⁴⁸ 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).

⁴⁹ 15 U.S.C. 78o-3(b)(6).

promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA's proposal would allow the use of transaction-based stop orders and stop limit orders by providing a uniform definition of "stop order" and "stop limit order" while also allowing member firms to offer order types that are triggered by an event other than a transaction (e.g., a quotation).⁵⁰ The Commission notes that a member that provides an order type that is triggered by an event other than a transaction at the stop price cannot label the order type a "stop order" or a "stop limit order," and must clearly distinguish the order type from a "stop order" and a "stop limit order."⁵¹ In addition, the member must disclose to the customer, in paper or electronic form, prior to the time the customer places the order, a description of the order type including the triggering event.⁵²

While several commenters advocated for an alternative approach and raised concerns regarding a potential burden as a result of the proposal, the Commission believes that FINRA's proposal would allow members flexibility in the types of orders they offer and provide for disclosure to customers regarding the operation of such orders. In this regard, the Commission notes that FINRA weighed various alternatives and took into account extensive input from its members in formulating the proposal.⁵³ In addition, the Commission notes FINRA's belief that the proposal should not impose additional costs on firms that continue existing practices consistent with FINRA rules.⁵⁴ Further, the Commission notes FINRA's concern that permitting

⁵⁰ See Proposed FINRA Rule 5350.

⁵¹ See Proposed FINRA Rule 5350, Supplementary Material .01.

⁵² See id.

⁵³ See Notice, supra note 3, at 33537; and FINRA Response at 2.

⁵⁴ See FINRA Response at 4.

stop order triggers to vary solely based on customer consent, as suggested by commenters, could undermine the ability of customers to understand how their stop orders would be handled.⁵⁵

The Commission believes that FINRA's proposal sufficiently addresses issues regarding FINRA's previous proposed rule change, which would have deleted in its entirety the provisions of FINRA Rule 6140 relating to the handling of stop orders by member firms.⁵⁶ The Commission believes that FINRA's proposal should enhance the ability of investors to understand the key attributes of order types offered by their brokers so that they can make informed choices as to whether to use a particular type of order.

⁵⁵ See id.

⁵⁶ See Securities Exchange Act Release No. 63885 (February 10, 2011), 76 FR 9062 (February 16, 2011) (Order Disapproving SR-FINRA-2010-055).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁷ that the proposed rule change (SR-FINRA-2012-026) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵⁸

Kevin M. O'Neill
Deputy Secretary

⁵⁷ 15 U.S.C. 78s(b)(2).

⁵⁸ 17 CFR 200.30-3(a)(12).