

Disruptive Quoting and Trading Activity

FINRA Adopts Rules on Disruptive Quoting and Trading Activity and Expedited Proceedings

Effective Date: December 15, 2016

Executive Summary

In December 2016, FINRA implemented two new rule changes regarding disruptive quoting and trading activity. The first rule change adopts new Supplementary Material .03 to Rule 5210 (Publication of Transactions and Quotations) to explicitly define and specifically prohibit for purposes of Rule 5210 two types of quoting and trading activity that are deemed to be disruptive. The first type of activity involves a party entering multiple limit orders on one side of the market that changes the level of supply and demand for the security, entering one or more orders on the opposite side of the market that are subsequently executed, and, following the execution, canceling the original limit orders. The second type of activity consists of a party placing an order inside the national best bid and offer, and then submitting an order on the opposite side of the market to execute against another market participant that joined the new inside market.

The second rule change amends the FINRA procedural rules regarding temporary cease and desist orders (TCDOs), found in the Rule 9800 Series, to create a process for FINRA to issue, on an expedited basis, a permanent cease and desist order against a respondent that engages in a frequent pattern or practice of the disruptive quoting and trading activity in Supplementary Material .03 to Rule 5210.

Questions concerning this *Notice* should be directed to

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Notice Type

- ▶ New Rule

Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Trading

Key Topics

- ▶ Cease and Desist Orders
- ▶ Disruptive Quoting and Trading
- ▶ Expedited Proceedings

Referenced Rules & Notices

- ▶ Rule 2010
- ▶ Rule 2020
- ▶ Rule 4330
- ▶ Rule 5210
- ▶ Rule 8210
- ▶ Rule 9200 Series
- ▶ Rule 9550 Series
- ▶ Rule 9800 Series
- ▶ SEA Rule 10b-5
- ▶ SEA Rules 15g-1 through 15g-9
- ▶ Section 10 of the Securities Exchange Act of 1934
- ▶ Section 15A of the Securities Exchange Act of 1934
- ▶ Section 17(a) of the Securities Act of 1933

Background & Discussion

Section 15A of the Securities Exchange Act of 1934 (Act) requires FINRA to have the capacity to enforce compliance by its member firms and persons associated with its member firms with, among other things, the Act, the rules and regulations thereunder, and FINRA rules.¹ FINRA's rules are required to be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,... to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest."²

In fulfilling these requirements, FINRA has developed a comprehensive regulatory program that includes automated surveillance of a substantial portion of trading activity in the U.S. securities markets.³ When FINRA identifies potentially disruptive, manipulative, or otherwise improper quoting and trading activity, FINRA conducts an investigation into the activity, which often includes requesting additional information from those involved.⁴ If FINRA identifies and confirms violations, FINRA will commence the enforcement process (either on its own behalf or on behalf of an RSA client exchange), which may result in, among other things, a censure, a requirement to take certain remedial actions, one or more restrictions on future business activities, a monetary fine, or a temporary or permanent ban from the securities industry.⁵

The process from the initial identification of potentially disruptive, manipulative, or improper quoting and trading activity to a final resolution of the matter can often take up to several years. Although this lengthy time period may be necessary and appropriate in complex cases, there are certain clear cases of disruptive and manipulative behavior, or cases where the potential harm to investors or market integrity is so clear, that there is an immediate need to initiate an expedited proceeding to stop the behavior from continuing. FINRA rules already provide FINRA with the ability to initiate an expedited proceeding in a number of different contexts (including in this context when safety to investors or the markets are impaired)—for example, the issuance of TCDOs under the Rule 9800 Series and bringing expedited proceedings for a variety of violations under the Rule 9550 Series. The rule changes described in this *Notice* serve to supplement these existing expedited processes to provide a new, specific and additional expedited procedure for certain defined types of disruptive quoting and trading activity.

Specifically, effective December 15, 2016, FINRA has implemented two new rule changes regarding disruptive quoting and trading activity. The first rule change adopts new Supplementary Material .03 to Rule 5210 to define and prohibit under this rule two types of specific conduct that are deemed disruptive quoting and trading activity. The second rule change amends the FINRA procedural rules regarding initiation of a TCDO process to create a process for FINRA to issue, on an expedited basis, a permanent cease and desist order against a respondent that engages in a frequent pattern or practice of the disruptive quoting and trading activity in Supplementary Material .03 to Rule 5210.⁶ Each of these rule changes is described in more detail below.

Disruptive Quoting and Trading Activity

FINRA has authority to prohibit and take action against manipulative trading activity, including disruptive quoting and trading activity, pursuant to federal securities laws and FINRA rules, including Rules 2010 and 2020, and in some instances, under pre-existing expedited proceeding rules.⁷ The new Supplementary Material .03 to Rule 5210 serves to define more specifically certain types of disruptive quoting and trading activity and, combined with the amendments to the procedural rules, provides that violations of the Supplementary Material can serve as the basis to apply the cease and desist proceeding described below. Specifically, the Supplementary Material prohibits firms from engaging in or facilitating disruptive quoting and trading activity as defined in the rule, including acting in concert with other persons to effect such activity.

The Supplementary Material defines two types of prohibited activities and states that, for purposes of the rule, disruptive quoting and trading activity would include a “frequent pattern or practice” of these activities.

- ▶ **Trading Scenario One:** a frequent pattern in which the following facts are present: (1) a party enters multiple limit orders on one side of the market at various price levels; (2) following the entry of the limit orders, the level of supply and demand for the security changes; (3) the party enters one or more orders on the opposite side of the market that are subsequently executed; and (4) following the execution, the party cancels the original limit orders.
- ▶ **Trading Scenario Two:** a frequent pattern in which the following facts are present: (1) a party narrows the spread for a security by placing an order inside the national best bid and offer and (2) the party then submits an order on the opposite side of the market that executes against another market participant that joined the new inside market established by the party.

Supplementary Material .03 to Rule 5210 does not include an express intent element and also makes clear that the order of the events indicating the pattern does not change the applicability of the rule. Moreover, these types of disruptive quoting and trading activity can occur regardless of the venue(s) on which the activity is conducted.

Cease and Desist Proceeding

In addition to the new Supplementary Material describing the prohibited quoting and trading activity, FINRA has amended its existing TCDO rules to establish a process for FINRA to issue, on an expedited basis, a permanent cease and desist order (PCDO) for violations of Supplementary Material .03 to FINRA Rule 5210.⁸

Under the current TCDO rules, FINRA can initiate a TCDO proceeding when respondents are alleged to have violated certain specific rules.⁹ Under the amendments, FINRA can issue a PCDO under which a respondent to the proceeding would be (1) ordered to cease and desist from the violative activity under Supplementary Material .03 to Rule 5210 or (2) ordered to cease and desist from providing market access to a client engaged in the violative trading activity.¹⁰

The process for issuing a PCDO for violations of Supplementary Material .03 to Rule 5210 closely follows the existing TCDO procedures. Specifically, like a TCDO, the following provisions apply to a PCDO proceeding for alleged violations of the new Supplementary Material:

- ▶ Only FINRA's chief executive officer (or such other senior officer as the CEO may designate) may initiate a PCDO proceeding under the rule;¹¹
- ▶ The PCDO proceeding is initiated by service of a notice, effective upon service, stating whether FINRA is requesting that the respondent take action or refrain from certain action, and the notice must be accompanied by a declaration of facts, a memorandum of points and authorities, and a proposed order containing the required elements of an order;¹²
- ▶ A hearing is conducted by a hearing panel,¹³ and the rules include provisions regarding the conduct of the hearing and generally require that the hearing be held within 15 days of service of the notice initiating the proceeding;¹⁴
- ▶ The hearing panel must issue a written decision no later than ten days after receipt of the hearing transcript;¹⁵
- ▶ The PCDO must set forth the alleged violation and the significant market disruption or investor harm that is likely to result without the issuance of an order and describe in reasonable detail the act or acts the respondent is to take or refrain from taking;¹⁶
- ▶ The PCDO is effective upon service and remains effective and enforceable unless modified, set aside, limited, or revoked pursuant to the rule;¹⁷
- ▶ Any time after the respondent is served with a PCDO, a party to the proceeding may apply to the hearing panel to have the order modified, set aside, limited, or suspended, and the hearing panel must generally respond to any such request in writing within ten days after receipt of the request;¹⁸
- ▶ FINRA can initiate an expedited proceeding pursuant to FINRA Rules 9556 and 9559 for violations of a PCDO;¹⁹
- ▶ Sanctions issued under the rule constitute final and immediately effective disciplinary sanctions thus allowing the respondent to appeal the PCDO to the SEC; however, filing an application for review with the SEC does not stay the effectiveness of the PCDO unless the SEC otherwise orders;²⁰ and
- ▶ The issuance of the PCDO does not alter FINRA's ability to further investigate the matter or later sanction the firm pursuant to its standard disciplinary process for violations of supervisory obligations or other violations of FINRA rules or the Act.

FINRA anticipates that the issuance of a PCDO under the new rule amendments will be limited to those extreme circumstances where initial attempts to resolve the conduct with the firm are unsuccessful.

Endnotes

1. See 15 U.S.C. 78o-3(b)(2).
2. 15 U.S.C. 78o-3(b)(6).
3. FINRA conducts, on its own behalf, surveillance of its member firms' trading activity, as well as surveillance for numerous national securities exchanges pursuant to Regulatory Services Agreements (RSAs). FINRA currently has RSAs with 18 different exchanges to perform some degree of surveillance. FINRA also combines its own data with data received from those exchanges with which it has RSAs to conduct cross-market surveillance.
4. See, e.g., Rule 8210.
5. 15 U.S.C. 78o-3(b)(7). See generally Rule 9200 Series.
6. The new rules are similar to those recently adopted by other self-regulatory organizations such as Bats BZX Exchange, Inc., formerly known as BATS Exchange, Inc. (BATS), and The Nasdaq Stock Market LLC (Nasdaq) but, as noted above, build off FINRA's existing process for issuing TCDOs. See Securities Exchange Act Release No. 77171 (February 18, 2016), 81 FR 9017 (February 23, 2016); see also Securities Exchange Act Release No. 77913 (May 25, 2016), 81 FR 35081 (June 1, 2016).
7. These rule changes are not meant to limit the types of manipulative or disruptive activity that can be pursued under pre-existing rules.
8. FINRA has existing authority to issue PCDOs. See Rule 9291. In addition, FINRA has the existing ability to bring expedited proceedings in a number of circumstances, including, for example, if a member firm, associated person, or other person does not meet the prerequisites for access to services offered by FINRA or cannot be permitted to continue to have access to services offered by FINRA or a member thereof with safety to investors, creditors, members, or FINRA. See Rule 9555(a)(2); see also, e.g., Rules 9551-9554. These rule changes are not meant to limit any other expedited procedures that could be taken pursuant to other rules.
9. FINRA has the authority to initiate a TCDO for alleged violations of Section 10(b) of the Act and Rule 10b-5 thereunder; SEA Rules 15g-1 through 15g-9 concerning penny stocks; FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) if the alleged violation is unauthorized trading, or misuse or conversion of customer assets, or based on violations of Section 17(a) of the Securities Act of 1933; FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices); or FINRA Rule 4330 (Customer Protection – Permissible Use of Customers' Securities) if the alleged violation is misuse or conversion of customer assets. See Rule 9810(a).
10. Under the current TCDO rules, FINRA must file an underlying complaint at the same time it issues a TCDO notice if a complaint has not already been filed. See Rule 9810(d). A TCDO remains in effect only until the conclusion of the underlying disciplinary proceeding. See Rule 9840(c). Under the new PCDO provisions, a PCDO is permanent, and there is no required underlying disciplinary proceeding. The new provision, however, does not preclude FINRA from pursuing a separate disciplinary action for the underlying conduct.

11. *See* Rule 9810(a).
12. *See* Rule 9810(a), (b).
13. *See* Rule 9820.
14. *See* Rule 9830(a).
15. *See* Rule 9840(a).
16. *See* Rule 9840(a).
17. *See* Rule 9840, 9850.
18. *See* Rule 9850.
19. *See* Rule 9860, 9556, 9559.
20. *See* Rule 9870.