

MEMO# 23898

October 26, 2009

FINRA Proposes to Modify Rules for Clearly Erroneous Trades

[23898]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 47-09
ETF ADVISORY COMMITTEE No. 37-09 RE: FINRA PROPOSES TO MODIFY RULES FOR
CLEARLY ERRONEOUS TRADES

The Financial Industry Regulatory Authority (“FINRA”) has proposed to amend its rules governing clearly erroneous executions to coordinate with the “model” rules approved by the Securities and Exchange Commission for stock trades across the U.S. equities markets. [\[1\]](#) FINRA’s proposed rules for clearly erroneous over-the-counter (“OTC”) executions in exchange-listed securities generally would mirror those of the model rules. [\[2\]](#) The proposed rules for OTC equity securities would differ slightly with respect to the numerical guidelines used to evaluate the eligibility of trades for consideration as “clearly erroneous.”

General Guidelines

The proposed rules would define the term “clearly erroneous” to specify when there is an obvious error in any term, such as price, number of shares, or other unit of trading, or identification of the security. The proposed rules would be accompanied by supplementary material that would explain that a transaction generally qualifies as clearly erroneous when there is a systemic problem that involves a large number of parties or trades, or a condition where it would be in the best interests of the market. In addition, the proposal would state that extraordinary market conditions may include situations where an extraordinary event has occurred, or is ongoing, that has had a material effect on the market for a security traded OTC or has caused major disruption to the marketplace. [\[3\]](#)

The proposal would clarify that all reviews of clearly erroneous trades by FINRA would be conducted on FINRA's own motion; members would not be permitted to initiate review of transactions. In addition, a FINRA officer would have only the authority to break trades, not to adjust them. Absent extraordinary circumstances, a FINRA officer would be required to take action generally within 30 minutes after becoming aware of a transaction involving an exchange-listed security. When extraordinary circumstances exist, action would be taken no later than the start of trading on the day following the date of execution for the trade under review. For OTC equity securities, the proposed rule change would require a FINRA officer to make a determination as soon possible after becoming aware of the transaction, but in all cases by 3:00 p.m. Eastern Time on the next trading day following the date of the transaction at issue. Appeals would be made in writing, having been received within 30 minutes after the person making the appeal is given the notification of the determination being appealed.

Exchange-Listed Securities Transactions

The proposed rules would generally follow the determination of a national securities exchange to break a trade for OTC transactions in exchange-listed securities that are reported to FINRA. Specifically, FINRA would replicate the numerical thresholds used by the exchanges to determine whether a transaction is eligible for consideration as clearly erroneous. [\[4\]](#) When multiple exchanges have related trades, FINRA would leave a trade unbroken when any of those exchanges has done so at or near the price range in question, and at or near the time in question, such that FINRA breaking the trade would be inconsistent with market integrity and investor protection. On the other hand, if there is no corresponding or related on-exchange trading activity, FINRA generally would make its own clearly erroneous determination.

OTC Equity Securities Transactions

Although the proposed rules for OTC equity securities would be structured similarly to those for exchange-listed securities, the numerical guidelines used to determine whether a transaction is eligible for clearly erroneous consideration would differ. FINRA would codify its current numerical guidelines, which are based on a sliding scale, as follows: [\[5\]](#)

Reference Price Numerical Guidelines (Subject Transaction's Percentage Difference from the Reference Price) \$0.9999 and under 20% \$1.0000 and up to and including \$4.9999 Low end of range minimum 20% -

High end of range minimum 10% \$5.0000 and up to and including \$74.9999 10% \$75.0000 and up to and including \$199.9999 Low end of range minimum 10% -

High end of range minimum 5% \$200.0000 and up to and including \$499.9999 5% \$500.0000 and up to and including \$999.9999 Low end of range minimum 5% -

High end of range minimum 3% \$1,000.0000 and over 3%

The proposed rule change also would state that FINRA does not expect to use its clearly erroneous authority in most situations, but that it expects the parties to settle any dispute privately.

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endnotes

[1] See SEC Release No. 60851 (October 21, 2009) (“Proposal”), available at: <http://www.sec.gov/rules/sro/finra/2009/34-60851.pdf>.

[2] See [Memorandum](#) to Equity Markets Advisory Committee No. 40-09 and ETF Advisory Committee No. 31-09 [23858] on October 8, 2009.

[3] The proposed rule change would clarify that FINRA’s authority regarding clearly erroneous trades would not extend to suspicious trading activities such as unauthorized trading activity or attempts to manipulate stock prices by illegally gaining access to legitimate accounts or opening new accounts using false information. Such conduct would be considered fraud and would be addressed by the appropriate FINRA rules.

[4] Under the model rules, an exchange will consider breaking a trade only if the price exceeds the consolidated last price by more than a specified percentage amount (e.g., 10% for stocks priced under \$25, during normal trading hours).

[5] In the sliding scale, the maximum percentage deviation would apply to the lower execution price in the range and the minimum percentage would apply to the higher execution price in the range.