Regulatory Notice 15-46

Best Execution

Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets

November 2015

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Trading

Key Topics

- Best Execution
- Directed Orders
- Equity Securities
- Fixed Income Securities
- Payment for Order Flow
- Regular and Rigorous Review
- Standardized Options

Referenced Rules & Notices

- FINRA Rule 3110
- FINRA Rule 5310
- MSRB Regulatory Notice 2014-02
- Notice to Members 06-58
- Notice to Members 01-22
- Notice to Members 99-12
- Notice to Members 97-57
- Rule 605 of SEC Regulation NMS
- Rule 606 of SEC Regulation NMS
- Rule 611 of SEC Regulation NMS
- SEA Rule 10b-10

Executive Summary

In light of the increasingly automated market for equity securities and standardized options, and recent advances in trading technology and communications in the fixed income markets, FINRA is issuing this *Notice* to reiterate the best execution obligations that apply when firms receive, handle, route or execute customer orders in equities, options and fixed income securities. FINRA is also issuing this *Notice* to remind firms of their obligations, as previously articulated by the Securities and Exchange Commission (SEC) and FINRA, to regularly and rigorously examine execution quality likely to be obtained from the different markets trading a security. FINRA also welcomes comments on whether there are other topics related to best execution for which additional guidance would be helpful. Any such comments can be emailed to *pubcom@finra.org*.[1]

Questions concerning this *Notice* or FINRA Rule 5310 should be directed to:

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Background and Discussion

Best execution of customer orders is a key investor protection requirement. In light of the increasingly automated nature of the equities, options and fixed income markets, firms need to regularly review their systems and procedures relating to obtaining best execution for their customers' orders. The purpose of this *Notice* is to remind firms of their obligations to provide best execution, reiterate best execution principles particularly relevant in automated markets and provide guidance on conducting regular and rigorous reviews. This *Notice* provides both general guidance on best execution obligations for firms when handling customer orders and more specific guidance on issues that have recently arisen in the fixed income market. Firms should review their systems and procedures to ensure they are designed to incorporate and reflect the best execution principles and the guidance provided herein.

1. The Duty of Best Execution

As previously stated,[2] a broker-dealer's obligation to obtain best execution of a customer's order in any security is based, in part, on the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest, and also has been incorporated explicitly in FINRA rules.[3] As such, any broker-dealer, when acting as agent on behalf of a customer in a transaction, is under a duty to exercise reasonable care to obtain the most advantageous terms for the customer.[4] In addition, best execution duties also arise when a broker-dealer is trading in a principal capacity with a customer.[5] Broker-dealers that are FINRA members also have best execution obligations pursuant to FINRA Rule 5310.

The SEC has recognized that the scope of the duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders. The SEC has articulated a non-exhaustive list of factors that firms should consider as part of their best execution analysis as markets evolve: (1) the size of the order; (2) the trading characteristics of the security involved; (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (4) the cost and difficulty associated with achieving an execution in a particular market center.[6]

When a firm is routing order flow for automated execution, or internally executing such order flow on an automated basis, the SEC has indicated that simply obtaining the best bid or best offer (BBO) may not satisfy a firm's best execution obligation, particularly with respect to small orders.[7] Conversely, while a firm is required to seek the most favorable terms reasonably available under the circumstances of the transaction, such terms may not necessarily in every case be the best price available.[8] The SEC also has stated that the best execution analysis may evolve due to changes in the market that give rise to improved executions, including the opportunity to trade at more advantageous prices.[9] If different markets may be more suitable for different types of orders or particular securities, the broker-dealer will also need to consider such factors.[10] For example, the routing decisions for non-marketable orders may require a different analysis (*e.g.*, including fill rates in the analysis) than would be appropriate for marketable orders.

The broker-dealer duty of best execution has been codified in FINRA's best execution rule, Rule 5310. This rule provides that, "[i]n any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." The rule governs both transactions where the firm acts as agent for the account of its customer, and also where transactions are executed as principal.[11] Among the factors that will be considered in determining whether a firm has used "reasonable diligence" are:

a. the character of the market for the security (*e.g.*, price, volatility, relative liquidity and pressure on available communications);

b. the size and type of transaction;

c. the number of markets checked;

d. accessibility of the quotation; and

e. the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.[12]

As demonstrated by the language of Rule 5310, the determination as to whether a firm exercised reasonable diligence to ascertain the best market for the security and bought or sold in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions necessarily involves a "facts and circumstances" analysis.[13] In addition, a firm must make every effort to execute a marketable customer order that it receives fully and promptly.[14] For non-marketable orders, firms should regularly review their routing decisions as well as the policies and procedures in place regarding the monitoring of non-marketable orders to ensure their best execution obligations are met. Depending upon the particular set of facts and circumstances surrounding an execution, actions that in one instance may meet a firm's best execution obligation may not satisfy that obligation under another set of circumstances.

FINRA also reminds firms that they cannot transfer to another person their obligations to provide best execution to their customers' orders, although other firms may also acquire that best execution obligation.[15] Accordingly, when a firm receives customer orders from a routing firm for purposes of order handling and execution, both the routing firm and the executing firm have best execution obligations, although the routing firm and the executing firm may have different best execution obligations.[16] As such, a broker-dealer that routes all of its order flow to another broker-dealer without conducting an independent review of execution quality would violate the duty of best execution.[17]

2. Regular and Rigorous Review for Best Execution

An important focus of FINRA's examination program is the review of a firm's procedures to regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security. The requirement that a broker-dealer must "regularly and rigorously" examine the execution quality that is likely to be obtained from different venues has been articulated by the SEC in a variety of contexts.[18] FINRA has also incorporated the "regular and rigorous review" requirement into Rule 5310.[19] However, when routing or internally executing larger-sized orders in any security, regular and rigorous review alone (as opposed to an order-by-order review) may not satisfy best execution requirements, given that the execution of larger-size orders "often requires more judgment in terms of market timing and capital commitment."[20]

FINRA believes that, given developments in order routing technology, order-by-order review of execution quality is increasingly possible for a range of orders in all equity securities and standardized options. A firm that chooses not to conduct an order-by-order review for some orders must have procedures in place to ensure that it periodically conducts a regular and rigorous review of execution quality for those orders. Such periodic reviews of execution quality must be conducted on a security-by-security, type-of-order basis (*e.g.*, for equity securities, limit order, market order, and market on open order). Firms choosing to conduct a regular and rigorous review must conduct the reviews, at a minimum, on a quarterly basis; however, Supplementary Material .09 to Rule 5310 notes that firms should consider, based on the firm's business, whether more frequent reviews are needed.[21] FINRA has found that some firms, in reviewing their business, have determined that it is necessary to conduct their reviews more frequently than quarterly, with most of those firms conducting monthly reviews.[22]

Although FINRA has noted that a regular and rigorous review can satisfy a firm's best execution obligation for firms that route orders and for firms that internalize orders,[23] a firm's ability to rely on a regular and rigorous review applies only to the firm's initial determination whether to route an order and those orders ultimately routed outside of the firm. Any orders a firm determines to execute by internalizing would be subject to an order-by-order analysis of execution quality. Thus, while Supplementary Material .09 to Rule 5310 allows a firm to use a regular and rigorous review of execution quality, this standard only applies to a firm's initial determination whether to route an order and to its review of orders routed outside of the firm. Orders that a firm determines to execute internally are subject to an order-by-order best execution analysis.

When conducting its review of execution quality in any security, a firm should consider: (1) the price obtained, including the extent to which an execution results in price disimprovement (*i.e.*, instances where orders are executed at inferior prices);[24] (2) the extent to which an order may obtain price improvement at other venues;[25] (3) the likelihood that an order will be partially or fully executed; (4) the speed of execution; (5) the size of execution; (6) transaction costs; and (7) customer needs and expectations.[26] In addition, a firm should consider the factors listed below, as applicable, when considering its best execution obligations in equities, options or fixed income securities.[27] In the context of equity securities, FINRA notes that these requirements apply to customer non-marketable limit orders as well as market and marketable limit orders.

- In conducting its regular and rigorous review, a firm must determine whether any material differences in execution quality exist among the markets trading the security.[28] If so, a firm should take these differences into account in its customer routing arrangements or justify why it is not modifying its routing arrangements.[29]

- In formulating policies and procedures to review execution quality for customer transactions, firms should consider what procedures they use or would use for executing the same or similar transactions for their own firm accounts, even if such procedures are not required to be the same.
- A firm that routinely routes a customer order to multiple trading centers (internal or external) should regularly review the execution quality that results from this practice. For example, the firm should evaluate the latency attendant in routing a customer order (or portion of a customer order) to multiple ATSs, a practice of routing to a particular trading center (*e.g.*, an internal ATS) before other routing decisions are made, or repeated routing to the same ATS, and whether such practices may result in latency that impacts fill rates or the overall quality of execution. The firm should also examine whether any of these practices may result in information leakage, and the impact of any information leakage on execution quality. Firms should consider the risk of information leakage by routing orders to a particular venue in light of the fill rates achieved at that venue and carefully assess whether the risks outweigh the potential for an execution.
- A firm that limits its review of execution quality only to those markets to which it currently routes customer order flow without considering competing markets would not satisfy the duty of best execution.[30] Accordingly, the firm must compare the quality of the executions it is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that it could obtain from competing markets.[31] This obligation would include reviewing new markets and trading centers that become available as potential markets to which the firm may route orders; thus, a firm should regularly consider execution quality at venues to which it is not connected and assess whether it should connect to such venues.
- Some firms may employ "filters," which generally refers to automated tools that allow the firm to limit its trading, with, for example, specific parties or parties with specified attributes with which it does not want to interact. If a firm uses filters on counterparties or filters on specific securities intended to limit accessing bids or offers in those securities, they may be used only for a legitimate purpose consistent with obtaining the most favorable executions for customers, and should be reviewed on a periodic basis and adjusted as needed. The firm, accordingly, should have policies and procedures in place that govern when and how to reasonably use filters without negatively impacting the quality of execution; periodically reevaluate their use; and determine whether to lift them upon request.[32]
- A firm must take into account market and technology changes that might alter its best execution analysis.[33]
- With respect to customer limit orders for equity securities, a firm must consider any material differences in execution quality (*e.g.*, the likelihood of execution) among the various markets to which orders may be routed.[34]

An introducing firm may rely on the executing firm's regular and rigorous review of execution quality for any security, so long as the executing firm fully discloses the statistical results and rationale of its review to the introducing firm, and the introducing firm reviews both the methodology and the results of that review.[35]

3. Best Execution and Payment for Order Flow

The SEC has also addressed the concept of best execution and its relationship to the practice of payment for order flow in connection with equity securities and options. For example, while the SEC has previously stated that bulk order routing "based, in part, on the receipt of payment for order flow is not, in and of itself, a violation of" a broker-dealer's duty of best execution,[36] the SEC also has emphasized that payment for order flow may "raise concerns about whether a firm is meeting its obligation of best execution to its customer."[37] The SEC has stated that an order routing inducement, such as receipt of payment for order flow, cannot be allowed to interfere with a broker-dealer's duty of best execution.[38] Similarly, firms should not allow access fees charged by particular venues to inappropriately affect their routing decisions, and, in general, a firm's routing decisions should not be unduly influenced by a particular venue's fee or rebate structure. Rule 5310 also addresses the practice of payment for order flow as it relates to best execution. Specifically, Supplementary Material .09 states that a firm should consider the existence of internalization or payment for order flow arrangements when conducting its regular and rigorous review of execution quality.[39]

The SEC has stated that the possibility of obtaining price improvement on an order is a heightened consideration when the broker-dealer is receiving payment for order flow.[40] Payment for order flow may encompass a broad variety of rebate and payment structures and practices. Specifically, SEA Rule 10b-10 defines payment for order flow to include "discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation."[41] Given the potential conflict between the receipt of payment for order flow, which is broadly defined under Rule 10b-10, and the duty of best execution, a firm should carefully evaluate its receipt of payment for order flow and the impact of such practices on execution quality.

4. Directed Orders

Firms may receive unsolicited orders for equity securities from customers that instruct the firm to route the orders to a particular market, often referred to as "directed orders." A firm's best execution obligations are somewhat different with respect to the execution of directed orders because the customer has provided the firm with a specific instruction as to where to route the order for execution.[42] Under Supplementary Material .08 to Rule 5310, a firm that is handling an unsolicited directed order is not required to undertake a best execution determination regarding the market of execution beyond the customer's

specific instruction.[43] However, the firm is still required to process that customer's order promptly and in accordance with the terms of the order. Furthermore, if a customer has directed that an order be routed to another specific broker-dealer that is also a FINRA member, the receiving broker-dealer to which the order was directed would be required to meet the requirements of Rule 5310 with respect to its handling of the order.

FINRA notes that, as a general matter, a firm is not obligated to accept directed orders. If a firm accepts a directed order from a customer, however, and has access to a trading center to which the customer requests that its order be directed, then the firm is obligated to act in accordance with the customer's instructions. If the firm is unable to route the order to the specific market in accordance with the customer's instructions, the customer must be informed of that fact and have been provided the opportunity to revise or cancel the order. Just as with a firm's regular and rigorous review, a firm has an obligation to periodically assess whether it should establish connectivity to trading centers, or terminate connectivity, when handling customer orders.

5. Additional Considerations for Best Execution for Fixed Income Securities

The market for fixed income securities has evolved significantly in recent years. Some firms have reduced their inventory positions in response to market and regulatory influences and the use of electronic trading systems, including dark and lit ATSs, continues to grow. In addition, transaction prices for most fixed income securities are now widely available to market participants and investors. Although the amount of pre-trade pricing information (*e.g.*, bids and offers) available also has increased, it is still relatively limited as compared to equities and generally not readily accessible by the investing public. While new technology and communications in the fixed income market have advanced, the market remains decentralized, with much trading still occurring primarily through individual dealers.

As the availability of electronic systems that facilitate trading in fixed income securities increases, firms need to determine whether these systems may provide benefits to their customer order flow, particularly retail order flow, and help ensure they are meeting their obligations under the rule with respect to ascertaining the best market for their customer transactions. Similarly, pre-trade transparency, such as through electronic trading platforms, is also increasing in the fixed income markets, although predominantly for smaller orders, and firms need to routinely analyze and determine whether incorporating pricing information available from these systems should be incorporated into their best execution policies and procedures.

FINRA recognizes that different systems provide different levels of price information and execution functionality, and that a firm's analysis of the available pricing information offered by different systems may take these differences into account. Some systems, including auto-execution systems, both display prices and provide execution functionality, while other systems display prices but provide no execution functionality. Still other

systems, such as RFQ systems, may provide indications of interest but not display prices or provide execution functionality. As such, a firm that uses, for example, an auto-execution system should routinely analyze pricing information from other systems that offer bona fide, executable prices and determine whether those systems should be incorporated into the firm's best execution policies and procedures.

FINRA also notes that prices of a fixed income security displayed on an electronic trading platform may not be the presumptive best price of that security for best execution purposes, especially for securities that are illiquid or trade infrequently. Thus, although a firm should consider using this information as part of its reasonable diligence in determining the best market for the security, executing a customer order at the displayed price may not fulfill the firm's obligations, particularly if other sources of information indicate the displayed price may not be the best price available. For example, if , as disussed in more detail below, a firm regularly uses a reliable similar security analysis to establish prices, that firm may need to use particular care before executing a trade at a price that is displayed by a trading system if its similar security analysis suggests that the displayed price is not reflective of the market.

FINRA also recognizes that the market for fixed income securities differs from the market for equity securities and options and also can vary significantly depending on the specific fixed income product. For example, some fixed income securities may trade frequently, be highly liquid and have transparent, accessible and firm quotations available. Other fixed income securities do not have public quotations or frequent pricing information available, and may trade infrequently; however, some fixed income securities that are less liquid also are highly fungible, meaning that they trade like other, similar securities, and the pricing in these similar securities can be used as a basis for determining prices in the original security.[44] Given this significant variation in trading characteristics across fixed income securities, the best execution rule uses a "facts and circumstances" analysis by requiring that a firm use reasonable diligence to ascertain the best market for the security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. A key determinant in assessing whether a firm has met this reasonable diligence standard is the character of the market for the security itself, which includes an analysis of price, volatility and relative liquidity. FINRA also recognizes that orders may be handled and executed differently in the fixed income market than in the market for equity securities and options. Given such differences firms may determine that their review of execution quality for fixed income securities may be less frequent than that of equity securities or options.

In addition, Supplementary Material .03 to Rule 5310 specifically addresses the application of the best execution rule to the fixed income market when assessing the accessibility of a quotation. Supplementary Material .03 states that, when quotations are available, FINRA will consider the accessibility of such quotations when determining whether a firm has used reasonable diligence. However, Supplementary Material .03 also notes that

the accessibility of the quotation is only one of the non-exhaustive reasonable diligence factors set out in Rule 5310, and that, in the absence of accessibility, firms are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.

The duty of best execution does not necessarily require a firm to access every available platform that trades fixed income securities, especially given the differences in pricing information and execution functionality offered by different systems. For example, a firm may not need to post a bid-wanted on each RFQ platform for a sell order, or become a subscriber to every fixed income ATS to meet its best execution obligations. However, firms are required to evaluate the execution quality of the venues that they have access to and, to the extent information is reasonably available, regularly assess whether other venues to which a firm is not connected may provide the opportunity for best execution.[45] A firm should also have policies and procedures in place for determining when it will access platforms or engage in further conduct in seeking to execute a customer order (*e.g.*, when it will post a bid-wanted on a platform or reach out to other dealers). Firms must compare the quality of the executions they are obtaining for customers via current order routing and execution arrangements (including executing against orders as principal) to the quality of the executions that they could obtain from competing markets, including, for example, alternative trading systems or other electronic trading platforms, particularly for smaller size orders that may trade more frequently on these platforms.[46] This obligation may include, for example, reviewing TRACE data for previous executions in the security or similar securities and assessing existing, as well as new, markets and trading centers that become available as potential markets from which the firm can receive pricing information or to which it may route orders.

Supplementary Material .06 to Rule 5310 addresses instances where orders involve securities where there is limited quotation or pricing information available, which is not uncommon for many fixed income securities. In such instances, the firm must have written policies and procedures in place that address how the firm will determine the best inter-dealer market for such a security in the absence of pricing information or multiple quotations and must document its compliance with those policies and procedures.[47] For example, a firm should analyze pricing information based on other data, such as previous trades in the security, to determine whether the resultant price to the customer is as favorable as possible under prevailing market conditions.[48] Although a firm should generally seek out other sources of pricing information or potential liquidity when little or none is otherwise available, which may include obtaining quotations from other sources (*e.g.*, other firms with which the firm previously has traded in the security), FINRA recognizes that, in other instances, obtaining quotations from multiple sources could adversely affect execution quality due to delays in execution or other factors.[49] Consequently, a firm's procedures should include relevant factors in assessing when obtaining quotations or other pricing information from outside sources may and may not be appropriate. If pricing information related to that security, such as a firm's previous

trades in the security, or other pricing information, such as a quotation from another source or the use of an evaluated pricing service, is unavailable, a firm may also consider previous trades in a similar security, if that security and those previous trades constitute a reliable basis for comparison.

The following examples illustrate the application of best execution principles to fixed income transactions:[50]

Example 1

A firm uses Platform A to obtain pricing information and to execute transactions, although Platform B, which offers similar pricing information and execution functionality, consistently offers better prices for transactions in the same securities. The firm is not linked to Platform B. Is the firm obligated to link to Platform B, or should it otherwise modify its routing practices?

In exercising reasonable diligence to ascertain the best market for the security, a firm may consider a variety of factors, including the price that may be obtained at different venues, the accessibility of quotations at different venues, and the size and type of the transaction, among other things. In addition, firms should regularly evaluate the execution quality of venues to which they are connected, and of the venues to which they are not connected. While price may not always be the determinative factor when evaluating execution quality, given that Platform B consistently offers superior prices, it is likely that the firm's analysis would result in connecting to Platform B. In determining whether Platform B represents the best market for the security, however, the firm should also examine other factors set forth in Rule 5310.

Example 2

A firm uses Platform A to execute retail transactions and Platform B to execute institutional transactions. There is no size limitation that would prevent retail transactions from being executed on Platform B. Is it permissible for a firm to use different platforms to execute different customer transactions?

In exercising reasonable diligence to ascertain the best market for the security, a firm may consider a variety of factors, including the size and type of the transaction and the accessibility of the quotation. Given that there is no limitation on executing retail transactions on Platform B, however, and the fact that the firm already routes institutional orders to Platform B for execution, the firm should thoroughly evaluate whether retail customer orders would obtain superior executions if routed to Platform B for execution.

Example 3

After receiving a customer sell order for a particular bond, a firm checks Platform A for bids and, finding no bids on Platform A, calls several other firms to solicit a bid. Following this outreach, the firm conducts a bid-wanted process; however, no bids are received. Is the firm obligated to seek out prices or solicit bids on other platforms, even if this would require the firm to subscribe to such platforms?

In exercising reasonable diligence to ascertain the best market for the security, a firm may consider a variety of factors, including the number of markets checked. If a firm generally receives bids on Platform A in response to a bid-wanted process, then the firm may not be obligated to connect to other platforms, unless other factors set forth in Rule 5310 indicate that other platforms represent the best market for the security. If, however, the firm regularly receives no bids on Platform A in response to a bid-wanted process, then the firm should evaluate the liquidity and accessibility of other platforms in determining whether to connect to such platforms. If the firm ultimately intends to buy the bonds from the customer as principal, best execution continues to apply, and the firm would need to have a reasonable basis for establishing the price to the customer, which, under the circumstances described above, may include reviewing previous trades in the same bond, similar securities, or both pursuant to the process established in the firm's policies and procedures.

Extreme Market Conditions

In the potential event of extreme market conditions impacting the trading of fixed income securities (*e.g.*, a shortage of liquidity and divergent prices during periods of significant ratings changes or interest rate movements), a firm should consider establishing and implementing procedures that are designed to preserve the continued execution of customers' orders in a manner that is consistent with the firm's best execution obligations while also recognizing and limiting the exposure of the firm to extraordinary market risk. A firm should consider the following guidelines when evaluating its best execution procedures during extreme market conditions:

- The treatment of customer orders must remain fair, consistent, and reasonable.
- To the extent that a firm's order handling procedures are different during extreme market conditions, the firm should disclose to its customers the differences in the procedures from normal market conditions and the circumstances in which the firm may generally activate these procedures.[51]
- Activation of procedures designed to respond to extreme market conditions may be implemented only when warranted by market conditions. Excessive activation of modified procedures on the grounds of extreme market conditions could raise best execution concerns. Accordingly, firms should document the basis for activation of their modified procedures.

Ultimately, a facts and circumstances analysis is neccessary to determine whether actions taken by a firm during extreme market conditions are consistent with the duty of best execution, but FINRA recognizes that market conditions are an important factor in the firm's best execution determination.

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The structure of the fixed income, equity and options markets continues to evolve. As the SEC stated in the Order Execution Obligations Release, "[t]he scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders.... As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become "reasonably available.""[52] Firms are reminded to routinely review and assess their systems and procedures relating to obtaining best execution for their customers' orders, particularly in light of advances in trading technology and communications, and consider how these changes may afford new opportunities for more favorable executions for customer orders.

Endnotes

1. FINRA believes the guidance in this *Notice* is consistent in all material respects with guidance on best execution obligations on transactions in municipal securities published by the MSRB on November 20, 2015, except where the rule or context otherwise specifically requires. The two instances where material differences exist with the MSRB's guidance are with respect to (1) the regular and rigorous review of execution quality required by members, and (2) the timeliness of executions consistent with reasonable diligence. *See* Section 2 (Regular and Rigorous Review for Best Execution); MSRB Implementation Guidance on MSRB Rule G-18, On Best Execution, note 12 and accompanying text; Section 1 (The Duty of Best Execution); MSRB Implementation Guidance on MSRB Rule G-18, On Best Execution, Section VI.1. FINRA and the MSRB will continue to work together with the goal of ensuring that their guidance on best execution obligations remains consistent in all material respects, unless differentiation is necessary due to differences in the markets for municipal or corporate fixed income securities or their respective rules.

2. *See, e.g., Notice to Members 06-58* (October 2006); *Notice to Members 01-22* (April 2001); *Notice to Members 99-12* (February 1999); and *Notice to Members 97-57* (September 1997).

3. *See* Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55007 at n.15 (November 2, 1994) ("Payment for Order Flow release") (citing Restatement 2d Agency Sections 387; 424 (1958)); *see also Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 270 (3d Cir. 1998).

4. *See* Payment for Order Flow release, 59 FR at 55007 n.15.

5. *See* Rule 5310(e); *see also* SEC Market 2000 Report, Study V (January 1994).

6. *See* Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75418 (December 1, 2000) ("Disclosure of Order Execution and Routing Practices release"); *see also* Payment for Order Flow release, 59 FR at 55008 n.25.

7. *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48323 (September 12, 1996) ("Order Execution Obligations release"). *See also In the Matter of Scottrade, Inc.*, Securities Exchange Act Release No. 58012 (June 24, 2008). In that case, the SEC found that the firm willfully violated Section 15(c)(1)(A) of the Act, which prohibits the making of material misrepresentations in connection with the execution of customer orders, where the firm represented to customers that it would provide customers with the opportunity to receive executions that were superior to the NBBO, but, for pre-open orders in Nasdaq securities, routed such orders to previously selected market centers using pre-programmed routing, and did not evaluate whether other venues offered prices superior to the NBBO for such orders.

8. *See* Disclosure of Order Execution and Routing Practices release, 65 FR at 75420. Although Rule 611's general prohibition on trading through a protected quotation can help ensure that customer orders are not executed at prices that are inferior to the best protected bid or offer, the SEC emphasized that Rule 611 "in no way lessens a broker-dealer's duty of best execution." *See* Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, at 37537 (June 29, 2005); *see also* 17 CFR 242.611. Rather, Rule 611 "undergirds" a firm's best execution obligation and serves as a minimum requirement, and compliance with Rule 611 does not necessarily equate with satisfaction of best execution. *See id.* at 37538.

9. *See* Order Execution Obligations release, 61 FR at 48323.

10. *See id.*

11. *See* Rule 5310(e).

12. Rule 5310(a)(1). The exercise of reasonable diligence to ascertain the best market under prevailing market conditions can be affected by the market data, including specific data feeds, used by a firm. For example, a firm that regularly accesses proprietary data feeds, in addition to the consolidated SIP feed, for its proprietary trading, would be expected to also be using these data feeds to determine the best market under prevailing market conditions when handling customer orders to meet its best execution obligations.

13. Because a determination regarding whether a firm has used reasonable diligence is a "facts and circumstances" analysis, firms should consider documenting their compliance with the rule with respect to trading in equities, options and fixed income securities. More generally, FINRA also notes that Rule 3110 requires members to have written policies and procedures in place that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. *See* Rule 3110(b)(1). Although some firms may choose to document their compliance on a transaction-by-transaction basis, FINRA recognizes that there may be reasonable alternative approaches that would satisfy the requirements of FINRA rules

and be sufficient to demonstrate compliance. As discussed below, Supplementary Material .06 to Rule 5310 addresses instances where orders involve securities where there is limited quotation or pricing information available. In those instances, the firm must have written policies and procedures in place that address how the firm will determine the best inter-dealer market for such a security in the absence of pricing information or multiple quotations and must document its compliance with those policies and procedures.

14. *See* Supplementary Material .01 to Rule 5310. *See also In the Matter of Morgan Stanley & Co.*, Securities Exchange Act Release No. 55726 (May 9, 2007) (firm failed to seek best execution where a new trading mechanism improperly delayed the execution of certain held market orders, which the firm "had an obligation to execute without hesitation as required").

15. FINRA also notes that firms must maintain adequate resources to fulfill their best execution obligations and a firm's "[f]ailure to maintain or adequately staff an over-the-counter order room or other department assigned to execute customers' orders cannot be considered justification for executing away from the best available market." *See* Rule 5310(c).

16. *See* Supplementary Material .09 to Rule 5310. In contrast, a firm's duty to provide best execution in any transaction "for or with a customer of another broker-dealer" does not apply in instances when another broker-dealer is simply executing a customer order against the firm's quote.

17. *See* Office of Compliance Inspections and Examinations: Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (January 25, 2001); *see also Notice to Members 01-22* at 204 ("[A]n introducing firm has an obligation to conduct an independent review for execution quality.").

18. *See, e.g.*, Disclosure of Order Execution and Routing Practices release, 65 FR at 75418; *see also* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48323 (September 12, 1996) ("Order Execution Obligations release") (articulating this requirement in the context of the routing and execution of small customer orders); *Notice to Members 01-22* at 203 (April 2001).

    The SEC has clearly stated that the duty of best execution does not necessarily require broker-dealers with a large volume of orders to determine individually where to route each order, particularly with respect to small customer orders. *See* Disclosure of Order Execution and Routing Practices release, 65 FR at 75420; Order Execution Obligations release, 61 FR at 48323. Similarly, FINRA Rule 5310 and its Supplementary Material allow for a regular and rigorous review, as opposed to an order-by-order review, for firms that route customer orders to other broker-dealers for execution on an automated, non-discretionary basis, as well as for firms that internalize customer order flow. *See* Supplementary Material .09 to Rule 5310.

    In the Order Execution Obligations release, which adopted the Display Rule and amendments to the Quote Rule, the SEC noted that the amendments were designed, in part, to "narrow quotes, enhance market liquidity, and improve an investor's ability to monitor the quality of its executions." 61 FR at 48296. The SEC found that

the Display Rule "will increase the likelihood that limit orders will be executed," which is a result that "is consistent with the duty of best execution." *Id.*

19. *See* Supplementary Material .09 to Rule 5310.

20. *See Notice to Members 01-22* at n.13.

21. Supplementary Material .09(a) to Rule 5310; *see also Notice to Members 01-22* at 205. FINRA notes that reports on order execution pursuant to Rule 605 of Regulation NMS are required to be made available on a monthly basis. *See* 17 CFR 242.605(a).

22. FINRA understands that some firms may enter into contracts pursuant to which they agree in advance to send a portion (or all) of their customer order flow to another firm for handling and execution. FINRA notes that the existence of such a contract in no way alters a firm's best execution obligation to analyze and review the execution quality of the orders routed to that firm. Firms should ensure that such contracts do not inappropriately influence or constrain the firm in making its routing decisions based on the results of its regular and rigorous reviews for best execution.

23. *See* Securities Exchange Act Release No. 65579 (October 17, 2011), 76 FR 65549 (October 21, 2011).

24. *See* Order Execution Obligations release, 61 FR at 48323, Supplementary Material .09 to Rule 5310. FINRA believes that, given the requirements of Regulation NMS, trades at prices outside the best bid and offer for smaller orders should be rare. Firms should avoid and address such trades.

25. *See* Order Execution Obligations release, 61 FR at 48323; *see also* Payment for Order Flow release, 59 FR at 55009; Supplementary Material .09 to Rule 5310. For example, if a firm obtains price improvement at one venue of $0.0005 per share, and it could obtain mid-point price improvement at another venue of $0.025 per share, the firm should consider the opportunity of such mid-point price improvement on that other venue as part of its best execution analysis.

26. *See* Supplementary Material .09 to Rule 5310; *see also Notice to Members 01-22* at 205.

27. Although the price obtained in a transaction is a key element of the best execution analysis, the SEC has noted that execution price and speed "are not the sole relevant factors in obtaining best execution of investor orders," and rejected commenters' concerns that Rule 11Ac1-5 (now Rule 605) would over-emphasize the quantitative factors of execution price and speed in the best execution analysis. *See* Disclosure of Order Execution and Routing Practices release, 65 FR at 75418.

28. *See* Disclosure of Order Execution and Routing Practices release, 65 FR at 75420 n.33 (citing Order Execution Obligations release, 61 FR at 48323); *see also* Supplementary Material .09 to Rule 5310.

29. *See* Supplementary Material .09 to Rule 5310; *see also Notice to Members 01-22* at 204.

30. *See* Office of Compliance Inspections and Examinations: Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (January 25, 2001).

31. *See* Supplementary Material .09 to Rule 5310; *see also Notice to Members 01-22* at 204.

32. The scope of a firm's policies and procedures on the use of filters, as well as the periodic review and adjustment of their use, should be appropriate to the nature of the firm's business and, therefore, may be different than the policies and procedures used by other firms.

33. *See* Order Execution Obligations release, 61 FR at 48323 (noting that, because technology is rapidly making ECNs more accessible, "broker-dealers must regularly evaluate whether prices or benefits offered by these systems are reasonably available for purposes of seeking best execution").

34. *Id.*; *see also* Supplementary Material .09 to Rule 5310.

35. *See* Supplementary Material .09 to Rule 5310; *see also Notice to Members 01-22* at 204.

36. *See* Payment for Order Flow release, 59 FR at 55009 n.28. *See also* Disclosure of Order Execution and Routing Practices release, 65 FR at 75420 (a broker-dealer does not violate its best execution obligation solely because it receives payment for order flow).

37. *See* Payment for Order Flow release, 59 FR at 55007.

38. *Id.* at 55009.

39. Supplementary Material .09 to Rule 5310.

40. *See* Payment for Order Flow release, 59 FR at 55009.

41. 17 CFR 240.10b-10. In the 1994 Payment for Order Flow release, which adopted the current language for Rule 10b-10, some commenters (including most of the then-exchanges) argued that rebates and fee reductions are structurally different from other cash payments and should be excluded from the monetary definition of payment for order flow. *See* Payment for Order Flow release, 59 FR at 55008 n.20. One commenter suggested that exchange rebates and fees could constitute the economic equivalent of payment for order flow, provided that the arrangement exceeded the fee charged for executing the order. *Id.* at 55008. The SEC found that payment for order flow would "include a fee arrangement in which an exchange charges 50 cents per order but offers a $2.00 per order credit for agency orders, which can be used to offset other fees incurred on that exchange." *Id.* at 55008 n.23. However, payment for order flow would "not include fee arrangements in which the market's net charge for executing the order, after any discount, rebate, or credit, is greater than zero." *Id.*

42. Of note, directed orders are excluded from the order routing statistics required to be produced under Rule 606 of SEC Regulation NMS. *See* 17 CFR 242.606.

43. *See* Supplementary Material .08 to Rule 5310.

44. Given the wide variety of fixed income securities, it is impracticable to provide an exhaustive list of characteristics that qualify a bond as a "similar security" for these purposes. By way of example, however, issuer, credit rating, coupon, maturity, redemption features, sector and tax status are some factors a firm could use to identify similar bonds. Although the use of a similar security analysis may be less common in the corporate debt market than other debt securities such as municipal securities, to the extent that a firm uses a similar security analysis, its written policies and procedures should establish how it identifies similar securities, as well as how and when to consider the market for them for the purposes of complying with the best execution rule.

45. *See* Office of Compliance Inspections and Examinations: Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (January 25, 2001). Unlike in the equity market, where a firm may use a market center's report under Rule 605 of SEC Regulation NMS to evaluate execution quality, FINRA recognizes that a corollary does not exist for the fixed income markets.

46. *See* Supplementary Material .09 to Rule 5310; *see also Notice to Members 01-22* at 204.

47. *See* Supplementary Material .06 to Rule 5310. The documentation required in this area will necessarily depend on the content of the policies and procedures that the firm determines to adopt. Only by way of example, recognizing this dependence on the content of the policies and procedures, a firm could use records providing information displayed on an alternative trading system and reviewed by a trader prior to execution, records of periodic observation of traders, notations by traders or records of pre- or post-trade reviews. These are, however, only examples of documentation methods, and the rule provides sufficient flexibility to accommodate the diverse population of firms, which can adopt policies and procedures that are reasonably related to the nature of their business, including the level of sales and trading activity and the type of customer transactions at issue, and to allow firms to demonstrate that they had been sufficiently diligent in a manner that is different than that used by other firms.

48. *Id.*

49. FINRA notes that a dealer providing a price in response to a bid request or bid list presented to the dealer or other competitive bidding process would not be subject to a best execution obligation since the dealer has not accepted a customer order for the purpose of facilitating the handling and execution of such order. This situation is analogous to Supplementary Material .04 to Rule 5310 which draws a distinction between those situations in which a firm acts solely as the buyer or seller in connection with an order presented against the firm's quote as opposed to accepting an order for handling and execution.

50. These examples are relevant to firms' duty to connect to new trading venues and how firms execute against orders.

51. However, the disclosure of alternative order handling procedures that are unfair or otherwise inconsistent with the firm's best execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations.

52. *See* Order Execution Obligations release, 61 FR at 48322-23.