

## SECURITIES ALERT

July 2014

### FINRA TARGETS BROKER-DEALER ORDER ROUTING AND EXECUTION QUALITY OF CUSTOMER ORDERS

The Financial Industry Regulatory Authority ("FINRA") has initiated a potentially impactful examination of broker-dealer order routing and execution. FINRA recently issued a targeted examination letter ("Order Routing and Execution Quality of Customer Orders") to about ten broker-dealers requesting information on how they route customer orders (the audit targets were identified through FINRA's Order Audit Trail System).

#### A Growing Concern Regarding the Routing of Customer Orders

FINRA Rule 5310 (commonly referred to as the "best execution rule") requires broker-dealers to route customer orders so that customers receive the best possible prices in the market. There has been a growing concern among market watchers that certain broker-dealers may not be executing customer orders in the best interests of their customers. Most recently, in a June 2014 hearing of the Senate Permanent Subcommittee on Investigations, Senator Carl Levin suggested that broker-dealers frequently route orders to receive the highest possible rebate, regardless of the price paid by customers.

The examination letter, available on FINRA's [website](#), asks for information on broker-dealer policies and procedures, including an explanation for how the broker-dealer ascertains the best market for routing orders to ensure that the price is as favorable as possible for a customer. The letter also asks for information on whether the broker-dealer has a practice of routing customer market and/or limit orders to other broker-dealers for execution in return for a payment and/or other remuneration.

#### What This Means for the Broker-Dealer Industry

FINRA's focus on Rule 5310 fits within FINRA's overall enforcement priorities. In its 2014 Regulatory and Examination Priorities Letter, FINRA advised that it would continue to focus on broker-dealer conflicts of interest, as well as the execution prices market participants obtain for customers on exchange markets, such as "where a firm potentially ignores a favorable price on one options market and executes a trade on another market to the detriment of their customer." Note that FINRA apparently identified the broker-dealers receiving an examination letter based on a review of routing patterns on FINRA's Order Audit Trail System, which tracks trading activity for all National Market System ("NMS") stocks and over-the-counter ("OTC") equity securities.

To minimize potential FINRA (or Securities and Exchange Commission) scrutiny, broker-dealers should ensure that their operations comply with the requirements of Rule 5310 and, more broadly, with the requirement that a broker-dealer act in the best interests of its clients. At a minimum, a broker-dealer should have written supervisory procedures that address Rule 5310's best execution requirements, including that the broker-dealer will consider the due diligence factors set forth in the rule:

- the character of the market for the security;
- the size and type of transaction;
- the number of markets checked;
- the accessibility of the quotation; and
- the terms and conditions of the order as communicated to the firm.

A broker-dealer should also conduct "regular" and "rigorous" reviews of the execution of customer orders, including orders routed through other broker-dealers, with a particular focus on the payment

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and/or other remuneration the firm receives for such routing. See [Supplementary Material .09 to Rule 5310](#). Additional considerations would include monitoring for potential conflicts of interests regarding the venues where orders are routed and ensuring that the broker-dealer understands each venue's business model and operations.