June 16, 2023

Via Electronic Submission

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
Attention: Vanessa Countryman

**Re: File No. S7-32-22: Proposed Regulation Best Execution;
File No. S7-31-22: Order Competition Rule**

OTC Markets Group[1] is pleased to submit this comment letter in response to the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed Regulation Best Execution (the "Best Ex Proposal"), and its impact on the proposed Order Competition Rule (the "Auction Proposal").[2]

We operate the primary over-the-counter ("OTC") electronic trading market in the United States for over 12,000 equity securities. FINRA member broker-dealers use our Alternative Trading Systems to provide price transparency, source liquidity, and meet their best execution obligations.

Our markets were born out of the standards for equity trading codified in FINRA's longstanding best execution rule. What was once a phone book has fostered tremendous technological development over the decades. As a result, where FINRA's best execution obligation had previously incorporated the "three quote" rule, we now provide a real-time electronic network of competing liquidity providers from across the country. Our technology allows a diverse community of FINRA regulated brokers, market makers, and ATS matching engines to display firm prices and facilitate electronically accessible trade executions. As such, we play a unique role in helping brokers meet their best execution needs. We are broadly supportive of a broker's obligation to achieve the best execution experience on behalf of their customer. U.S. equity market structure is complex, distributed, and constantly evolving as marketplaces and broker-dealers compete for customers and market share. **FINRA's existing best execution regime has persisted over the years, evolved to harness technology, and continues to provide a robust, well-understood framework that ensures investors are receiving competitive executions under prevailing market conditions.**

[1] OTC Markets Group Inc. operates the OTCQX® Best Market, the OTCQB® Venture Market and the Pink® Open Market for 12,000 U.S. and global securities. Our OTC Link® Alternative Trading Systems (ATSs) provide critical market infrastructure that broker-dealers rely on to facilitate trading. Our innovative model offers companies more efficient access to the U.S. financial markets. OTC Link ATS, OTC Link ECN and OTC Link NQB are SEC regulated ATSs, operated by OTC Link LLC, member FINRA/SIPC.
[2] Order Competition Rule, SEC, 88 Fed. Reg. 128 (Jan. 3, 2023), available at www.govinfo.gov/content/pkg/FR-2023-01-03/pdf/2022-27617.pdf ("Auction Proposal"); Regulation Best Execution, SEC, 88 Fed. Reg. 5440 (Jan. 27, 2023), available at www.govinfo.gov/content/pkg/FR-2023-01-27/pdf/2022-27644.pdf ("Best Ex Proposal").

The duty of best execution predates federal securities laws and is rooted in common law agency and fiduciary principles. These principals were first codified in 1968 by FINRA's predecessor, the National Association of Securities Dealers (NASD). In the fifty-plus years since its original adoption, the broker-dealer industry has developed a sophisticated and interconnected architecture to meet the best execution standard that is codified and deeply embedded in human processes and software code. This best execution infrastructure includes layers of order management and routing systems, comprehensive compliance programs, and robust regulatory oversight from seasoned FINRA examiners.

It is in large part due to its extensive history that the current FINRA Rule 5310 (Best Execution and Interpositioning) works so well for investors across the listed and OTC equity markets. The FINRA best execution regime has proven to accommodate and incorporate changes in trading behavior, market structure, and technology. The rule mandates competitive executions, creates correspondent obligations for recipients handling downstream orders, and prohibits interpositioning of unnecessary intermediaries. Notably, the framework also already covers the type of "conflicted transactions" that the Best Ex Proposal seeks to address. Under existing FINRA rules and related guidance, member firms must not let payment for order flow ("PFOF") interfere with their duty of best execution.[3] FINRA Rule 5310 applies to retail firms acting as agent and market makers executing transactions on a principal basis, meaning that the duty of best execution exists throughout the order-handling process and cannot be offloaded or transferred from one firm to another.

Investors in smaller public companies, which are by their nature generally more thinly-traded, benefit from the existing, principles-based ruleset. The equities market (both listed and OTC) is largely driven by wholesale market makers that are willing to put up their own capital to ensure that investors can continuously buy and sell in an open market. FINRA's best execution framework accommodates this important function, allowing competition between brokers, dealers, ATS matching engines, and other market centers, while ensuring that investors can obtain the most competitive execution – whether they are trading in a megacap ADR or a small regional bank stock.

We do not believe that there is any need to supplement and complicate the existing FINRA best execution rule with an SEC standard. Notwithstanding, any SEC best execution rule must be merit-neutral to business model, principles-based, and premised on achieving *competitive* executions in light of different trading strategies, market structures, and liquidity profiles. As such, we provide the following feedback:

1. **Introducing new, potentially conflicting best execution requirements could break the existing FINRA regime.**

Since the original adoption of the best execution principles in 1968, FINRA has issued dozens of notices and provided written guidance to members, clarifying expectations and obligations and keeping pace with trends and technologies. Obfuscating the existing, well-understood

[3] *See* FINRA Regulatory Notice 21-23, FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow (Jun. 23, 2021), available at: https://www.finra.org/rules-guidance/notices/21-23.

FINRA framework with a new SEC standard will require firms to direct significant resources to developing new policies and procedures, analyzing internal controls, and reworking software code for order routing, trade execution, and compliance systems. Existing FINRA guidance that firms understand and rely on is likely to be called into question as discrepancies between the two regimes come to light. Industry confusion over conflicting and divergent requirements will outweigh any potential benefit to investors.

2. **The Commission has not properly evaluated the costs and systemic risks of the Best Ex Proposal on existing order handling processes.**

Changes to the Written Supervisory Procedures (WSPs) and the automated technology systems that support broker-dealer operations will be costly and time intensive. For example, complex order management systems (OMS) that route customer interest based on the best available market conditions will need to be recoded. Well-established and automated compliance checks and exception reports will need to be redefined. The imposition of another regulatory regime, with a different interpretation of the best execution standard, will create needless conflicts and costly operational risks. The Best Ex Proposal openly acknowledges that the Commission "lacks detailed information on broker-dealers' current policies and procedures with respect to best execution standards and order handling practices to determine how many broker-dealers would be required to change their order handling practices under the [Best Ex Proposal.]."[4] **Before moving forward with any final rulemaking, the Commission must more thoroughly examine the industry-wide costs of such a monumental regulatory change.**

3. **The Best Ex Proposal may reverse progress made in achieving zero-commission trading for retail investors.**

The Proposal would obligate broker-dealers to adopt rigorous policies and procedures for certain retail trades, including: (i) riskless principal transactions, (ii) affiliate transactions, and (iii) transactions involving PFOF (collectively, "Conflicted Transactions").

The vast majority of volume in OTC securities is facilitated via wholesale market-making firms that rely on PFOF from retail firms to support their business model. Accordingly, it is likely that a significant portion of transactions in OTC equity securities would fall within the Conflicted Transactions definition. By labeling executions from certain market centers as "Conflicted Transactions," the Best Ex Proposal is implying that liquidity directly provided as a principal is less meritorious than liquidity provided via exchanges that operate on an agency-plus-fees basis.

This clear bias against the market maker business model fails the fair competition statutory objective of Exchange Act Section 11A, which requires "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than

[4] Best Ex Proposal at 5524.

exchange markets”. [5] It also ignores the fact that firms accepting PFOF have pushed the industry towards a zero commission standard. While not all zero-commission retail brokers accept PFOF today, the competitive market price setting that consistently lowered or eliminated retail commissions stemmed from those firms that accepted PFOF. The Best Ex Proposal is poised to reverse this progress. Any economic impact analysis should focus on the price *setters*, not the followers.

4. **The proposed requirements for “Conflicted Transactions” would make it harder for brokers to provide liquidity for investors in thinly-traded securities.**

The Best Ex Proposal will further harm investors by reducing a broker’s willingness to transact in less liquid and thinly-traded securities. The Proposal acknowledges this outcome, stating that “liquidity provision in thinly traded and unlisted securities may decrease,” and “[t]o the extent that broker-dealers’ willingness to make markets in these securities decreases overall, this may increase trading costs for these securities and make it more difficult for companies to go public before they are eligible to be listed on registered exchanges.”[6]

The Best Ex Proposal would likely cause small company capital formation to suffer, but the Commission must not overlook the chilling effect that it will have on *investors* in these companies. Retail largely dominates the trading activity in smaller, thinly-traded companies on our markets, with sell-side flow often originating from early investors, employees, and management. These securities typically already have high transaction costs and constrained liquidity. We fear that the Best Ex Proposal will only serve to further discourage firms from handling transactions for investors in these companies.

5. **The Proposal does not recognize variance in trading strategies, market structure, and competitive forces.**

The Best Ex Proposal acknowledges that the Conflicted Transactions requirements “may be interpreted very differently by different broker-dealers, and may prove challenging in markets for some asset classes where the number of potential markets is limited and broker-dealers may effectively be checking all reasonably available prices in current practice.”[7] **Rather than classifying these transactions as “conflicted”, the Commission should instead reframe the obligation as requiring *competitive execution* and acknowledge that different venues offer different execution value for different types of assets.** For example, OTC Markets Group offers three different market structure models – from a fully-disclosed Qualified Interdealer Quotation System (“IDQS”) to anonymous ECN matching engines – that accommodate the vast range of broker-dealers, securities, and trading behavior in the OTC

[5] *See* 15 U.S.C. § 78k-1(a)(1)(C)(ii); *see also* Some Reflections on Competition and the National Market System, Securities and Exchange Commissioner Philip A. Loomis, Jr., Remarks at the Denver Institutional Securities Conference (Feb 5, 1976), available at: https://www.sec.gov/news/speech/1976/020576loomis.pdf (“[T]he job before us is to set up a mechanism both of facilities and of rules, which will make the order flow available to various markets centers and to make it possible for all to participate in it on equal terms. I believe that it is technically possible to make the order flow thus available and that rules can be devised to permit equal competitive access to it.”).
[6] Best Ex Proposal at 5537.
[7] Id. at 5534.

market.[8] High frequency trading firms making markets in highly liquid, mega-cap OTC ADRs may internalize orders or route them to our anonymized matching engine. Smaller companies, with a fraction of the daily trading volume of their larger counterparts, may trade by appointment. Smaller shareholder bases, less analyst coverage, lower trading volumes, and higher information asymmetry risk are all common features of smaller public companies that tend to result in fewer standing limit orders. Broker-dealers making markets in these thinly-traded securities frequently prefer to use our Qualified IDQS where they can quote and message with a network of fully-disclosed liquidity providers to achieve high-quality trade executions for their customers.

Despite the variety in how different markets function and different securities trade, the Best Ex Proposal primarily focuses on price as a determining factor in achieving best execution. For Conflicted Transactions in particular, the Commission should take a merit-neutral approach and focus on how firms can obtain *competitive execution* on or off exchange, without bias regarding agency or dealer business models, by analyzing security characteristics, market structure, order size, and other factors.

6. **The Best Ex Proposal will disadvantage smaller, specialized broker-dealers that service retail customers and provide liquidity in thinly-traded companies.**

If specialized broker-dealers cease providing liquidity in small company securities, the ultimate harm will be borne by investors in these companies. The Best Ex Proposal states that it “may increase barriers to entry and disadvantage smaller broker-dealers because of the increased compliance costs and resulting economies of scale that would result under the proposal.”[9] The Commission should undergo a comprehensive analysis of the downstream consequences of imposing this standard on smaller firms and their investors. For example, boutique broker-dealers that specialize in providing liquidity for certain subsets of the OTC equity market, such as the community banking or biotechnology sectors, would likely face significant costs associated with the heightened Conflicted Transaction standard.

7. **The definition of “retail customers” for the purpose of Conflicted Transactions should be consistent with industry practice under existing SEC and FINRA rules.**

Creating a new definition of a “retail customer” solely for purposes of the Conflicted Transaction standard would create needless confusion. To the extent the Commission proceeds with such a standard, it should leverage existing definitions that are consistent with industry practice.

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[8] OTC Link ATS offers a fully attributable, network-based model that allows subscribers to publish quotations, send trade messages, and negotiate trades with known counterparties. OTC Link ECN functions as a centralized matching engine and provides subscribers with anonymous order matching functionality. OTC Link NQB operates as a fully attributable IDQS and a centralized matching engine, allowing for distribution of depth-of-book market data.
[9] Id. at 5535.

8. **If the SEC's Auction Proposal is adopted, retail customers will suffer information leakage and decreased fill certainty that will *harm* execution quality and increase volatility.**

The Best Ex Proposal is just one of four massive market structure reforms released simultaneously. As many other commenters have noted, it is nearly impossible to analyze the impacts of one proposal in a vacuum, as each is highly dependent on the others. The Auction Proposal would require that certain retail customer orders be routed to an open auction operated by an agency-plus-fees exchange. The mandate is supposedly "designed to give broker-dealers sufficient flexibility to obtain best execution of individual orders in the full range of market conditions."[10] This "flexibility" is merely an illusion of choice. **The Auction Proposal would actually supplant the existing, principles-based FINRA best execution rule by *mandating* that brokers route to specified destinations and interpositioning an exchange business model.**

The Auction Proposal would force firms that otherwise have a best execution obligation to instead flash retail orders to an exchange. Inequitably, exchanges are not required to flash spread crossing market orders to market makers before executing at the exchange's own BBO. The Auction Proposal also boldly assumes that institutional investors – generally, *takers* of liquidity – would take the other side of retail orders sent to an exchange. It is far more likely that retail orders would be exposed to high frequency traders that do not have any correspondent obligations, thus signaling to the market that there is demand in the security and driving up the price. Furthermore, there is no certainty of a fill at the midpoint. Retail investors submitting market orders desire WYSIWYG executions – 'what you see is what you get.' Mandating flash auctions reduces the primary benefits of market orders: immediacy and certainty. This would in turn dampen liquidity, negatively impact pricing, and make it more difficult for brokers to fulfill their best execution responsibilities. Accordingly, rather than improving execution quality, the result may lead to worse execution quality for investors, contravening the stated purpose of the Best Ex Proposal.

We are also concerned that the Auction Proposal violates the intent of the existing FINRA best execution rule by interpositioning an exchange mechanism, which would bring additional costs, friction, and slippage. The Auction Proposal would shift competition and liquidity from regulated off-exchange market makers with FINRA correspondent and order protection obligations to anonymous, on-exchange high frequency traders with no correspondent obligations. By mandating that orders flow to an exchange venue over other market centers, the Auction Proposal also violates both the Congressional intent and letter of law under the fair competition objective of Section 11A.

Section 11A also declares, in a subordinate clause, that it is in the public interest to assure "an opportunity […] for investors' orders to be executed without the participation of a dealer" *but only if consistent with the other provisions of the section.* It appears that the Auction Proposal has subverted the Section 11A congressional mandate by seeking to eliminate the participation of a dealer without first ensuring that such a proposal is consistent with the fair competition objective. Notwithstanding, the Auction Proposal effectively swaps one type of dealer for

[10] 15 U.S.C. § 78k-1(a)(1)(C)(v).

another. Liquidity providers in the proposed flash auctions will not be the dreamed-of institutions, but rather high frequency trading firms, which simply changes the type of intermediary from a market maker to a high frequency trader.

We ask a further question: why doesn't a midpoint auction for retail market orders already exist? U.S. equity markets are the most competitive and efficient in the world. The imposition of a lab-grown market structure experiment removes customer choice, restricts innovation, and stifles competition. Any proposal to improve and enhance our markets must track each Section 11A objective, including fair competition. Congress has spoken and SEC rulemaking must be merit-neutral as to the business model (principal or agency) and venue (exchange or off-exchange). The SEC should not impose artificial market structures, pick winners and losers, or favor certain business models.

9. **The Commission should consider alternative order types and enhancing existing FINRA rules.**

As an alternative to the proposed retail auction model, broker-dealers could instead be required to offer retail investors a new order type that would allow users to ping the midpoint in a given security. Under this model, a retail investor entering their order could choose between a market order, limit order, or midpoint ping, which offer advantages regarding immediacy, certainty and price improvement, respectively. This would provide *more* choices for investors, without the Auction Proposal's downside of flashing investor interest to the market.

One of the great advancements in exchange and OTC equity trading is the ability of investors to choose a marketable order or a limit order. FINRA rules requiring limit order display empower investors that submit limit orders that match or improve the NBBO, thus encouraging price competition. Under these rules, retail investor orders are protected and broker-dealers are prohibited from trading for their own account at a price equal to or better than any standing retail investor orders. If the goal of the Proposal is to improve retail execution quality, the Commission should consider enhancing FINRA and MSRB limit order display, limit order protection, and market order protection requirements for retail investors across all classes of equity and debt securities. This approach would improve execution quality and investor choice in a consistent manner across all securities, without altering the competitive landscape and disrupting the technological advancements of our market infrastructure.

OTC Markets Group appreciates the opportunity to comment on the Best Ex and Auction Proposals. We welcome the opportunity to discuss our comments with the Commission.

Very truly yours,

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