FINRA

Financial Industry Regulatory Authority

September 9, 2008

Ms. Florence Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-FINRA-2008-011; Response to Comments

Dear Ms. Harmon:

On March 28, 2008, Financial Industry Regulatory Authority, Inc. or "FINRA" (f/k/a the National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission (the "SEC") proposed rule change SR-FINRA-2008-011 to amend its trade reporting rules applicable to over-the-counter ("OTC") equity transactions[1] to: (1) replace the current market maker-based trade reporting framework with an "executing party" framework; and (2) require that any member with the trade reporting obligation under FINRA rules that is acting in a riskless principal or agency capacity on behalf of one or more other members submit non-tape report(s)[2] to FINRA, as necessary, to identify such other member(s) as a party to the trade (the "original filing"). On April 24, 2008, the SEC published the proposed rule change for comment in the Federal Register.[3] The comment period closed on May 15, 2008. The SEC received four comment letters in response to the Federal Register

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1 Specifically, OTC equity transactions are: (1) transactions in NMS stocks, as defined in SEC Rule 600(b) of Regulation NMS, effected otherwise than on an exchange, which are reported through the Alternative Display Facility ("ADF") or a Trade Reporting Facility ("TRF"); and (2) transactions in "OTC Equity Securities," as defined in NASD Rule 6610 (e.g., OTC Bulletin Board and Pink Sheets securities), Direct Participation Program ("DPP") securities and PORTAL equity securities, which are reported through the OTC Reporting Facility ("ORF"). The ADF, TRFs and ORF are collectively referred to herein as the "FINRA Facilities."

2 As described in the original filing, "tape reports" are trade reports that are submitted to the tape for public dissemination purposes and "non-tape reports" are reports that are not submitted for public dissemination.

3 See Securities Exchange Act Release No. 57681 (April 17, 2008), 73 FR 22186 (April 24, 2008) (Notice of Filing of SR-FINRA-2008-011).

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publication.[4]

The commenters raise several issues relating to the proposed rule change that are summarized and responded to below.

Executing party trade reporting structure proposal

One commenter expressly supports the proposed executing party trade reporting structure, stating that it presents workable standards for clearly identifying the member with the responsibility for reporting a trade.[5] Another commenter states that it does not object to the proposed trade reporting structure,[6] while the other two commenters do not address this aspect of the proposed rule change.

The commenter supporting the proposed trade reporting structure asks for clarification with respect to several issues.[7] First, the commenter requests that FINRA clarify whether members that manually negotiate a trade (whether by telephone or electronic messaging) and seek to modify the proposed sell-side reporting default may use a previously executed "Attachment II" or other agreement to satisfy the documentation

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4 See Letter from Romeo Bermudez, Direct Edge ECN LLC, to Nancy Morris, Secretary, SEC, dated May 13, 2008 ("Direct Edge Letter"); Letter from Eric Swanson, BATS Trading, Inc., to Nancy Morris, Secretary, SEC, dated May 14, 2008 ("BATS Letter"); Letter from Ann Vlcek, Securities Industry and Financial Markets Association, to Nancy Morris, Secretary, SEC, dated May 15, 2008 ("SIFMA Letter"); and Letter from Philip Pinc, National Stock Exchange, to Nancy Morris, Secretary, SEC, dated May 29, 2008 ("NSX Letter").

5 SIFMA Letter.

6 BATS Letter.

FINRA notes that, subsequent to the submission of BATS Trading's comment letter, the SEC approved the application of BATS Exchange, Inc. for registration as a national securities exchange. As explained in the SEC's order, upon operation of BATS Exchange as a national securities exchange, BATS Trading will continue as a broker-dealer with the sole function of providing outbound order routing services to BATS Exchange. See, Securities Exchange Act Release No. 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182).

7 SIFMA Letter.

requirement under the proposed rule change.[8]

Where two members have entered into a "give up agreement,"[9] one member can "give up" or report on behalf of another member. However, where the contra party is giving up or reporting on behalf of the member with the trade reporting obligation under FINRA rules, the give up agreement does not shift the trade reporting obligation to the contra party. Rather, the member with the trade reporting obligation remains responsible for compliance with FINRA trade reporting rules and, for example, could be charged with late reporting if the member reporting on its behalf fails to submit the tape report within 90 seconds of execution. Thus, the give up agreement only permits one member to submit a trade report on behalf of another member. By contrast, the contemporaneous agreement in the context of manually negotiated trades under the proposed rule change can shift the trade reporting obligation under FINRA rules.

This distinction can be illustrated by the following example. Member A represents the sell-side and Member B represents the buy-side in a manually negotiated trade where both members satisfy the definition of "executing party." Under the proposed rule change, Member A, as the sell-side, has the reporting obligation. If the parties agree that Member B will report the trade and Member A contemporaneously documents the parties' agreement, the trade reporting obligation shifts to Member B, and Member B is responsible for reporting the transaction in accordance with FINRA rules. If, on the other hand, Member A and Member B do not have a contemporaneously documented agreement to shift the reporting obligation to Member B, but have a previously executed give up agreement, Member B can report the trade *on behalf of* Member A. However, Member A still has the trade reporting obligation under FINRA rules and is responsible for the trade report submitted on its behalf by Member B.

In order for the parties to shift the reporting obligation from Member A to Member B in this example by virtue of a previously executed give up agreement (instead of a contemporaneously documented agreement), the give up agreement must expressly contemplate this scenario (i.e., that in a manually negotiated trade between Member A and Member B where Member A, as the sell-side, has the reporting obligation, the parties agree that Member B will have the reporting obligation). FINRA notes that members' current give up agreements are not specific in this regard and would need to be amended or re-executed for this express purpose.

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8 As described in the original filing, under the proposed rule change, where both members may satisfy the definition of "executing party," such as in manually negotiated transactions, the member representing the sell-side has the trade reporting obligation, unless the parties agree otherwise and the sell-side member contemporaneously documents such agreement.

9 The Attachment II referred to by the commenter is a form of give up agreement.

In addition, the commenter asks that FINRA confirm that the member with the trade reporting obligation – whether the executing broker, sell-side broker, or as agreed upon by members negotiating manual trades pursuant to the proposed rule change – is responsible for timely and accurate trade reporting.[10] In particular, this commenter asks for confirmation that where two members in a manually negotiated trade have properly documented an agreement as to which member is responsible for reporting the trade, the other member is not responsible for reporting deficiencies with respect to the trade.

This commenter is correct that under the proposed rule change, the member with the trade reporting obligation is responsible for timely and accurate trade reporting (which is the case today). (The contra party is responsible for complying with any applicable order-entry firm reporting requirements, e.g., the "20 Minute Rule" under NASD Rule 6130(b).) Where the trade reporting obligation is shifted to the member representing the buy-side by virtue of a contemporaneously documented agreement under the proposed rule change, the member representing the sell-side is not responsible for such trade reporting deficiencies as the buy-side member's failure to submit the tape report within 90 seconds of execution.

Finally, in response to the commenter's request,[11] FINRA is clarifying that the proposed executing party trade reporting structure would not impact the processing of regulatory transaction fees pursuant to Section 3 of Schedule A to the By-Laws ("Section 3").[12] FINRA always bills Section 3 fees to the clearing member identified as the sell-side on the tape report, and as such, it makes no difference for billing purposes which member appears on the tape report as the reporting party and which member appears as the contra party.[13]

Non-Tape Reporting Proposal

All four commenters address the non-tape reporting proposal and they raise the

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10 SIFMA Letter.

11 SIFMA Letter.

12 Pursuant to Section 31 of the Act, FINRA and the national securities exchanges are required to pay transaction fees and assessments to the SEC that are designed to recover the costs related to the government's supervision and regulation of the securities markets and securities professionals. FINRA obtains its Section 31 fees and assessments from its membership, in accordance with Section 3.

13 See, e.g., Member Alert: Additional Guidance Regarding the Automated Reporting of Transactions Subject to a Regulatory Transaction Fee (November 17, 2006).

following issues.

First, three commenters assert that the proposed rule change does not meet the requirements of Section 15A(b)(5) of the Act[14] because it does not address the fees associated with the submission of non-tape reports.[15] The commenters' argument can be summarized as follows: FINRA charges each TRF for regulation based on the volume of tape and non-tape reports submitted to the TRF. The proposed rule change will increase the number of non-tape reports submitted to the TRFs, which will increase the regulatory charges paid to FINRA by the TRFs. The increased regulatory charges will, in turn, be passed along to FINRA members because one of the TRFs, the FINRA/NSX TRF, imposes a fee on TRF participants for the submission of non-tape reports designed to generate revenues for the TRF to cover some of its regulatory costs. FINRA should be required to demonstrate the basis for its regulatory charges to the TRFs under Section 15A(b)(5) of the Act. Without such a showing, the TRFs and FINRA members are unable to make a determination as to the reasonableness of such charges.

One of these commenters, a TRF Business Member,[16] also argues that it is competitively disadvantaged because it has difficulty passing on FINRA's regulatory charges to its TRF customers due to the lack of transparency and predictability of those charges.[17] This commenter argues that FINRA should publish for notice and comment a complete schedule relating to its charges for TRF regulation and explain the regulatory work that it performs relating to non-tape reports.

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14 15 U.S.C. 78o-3(b)(5). That section requires that:

> The rules of the association provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which the association operates or controls.

15 Direct Edge Letter, BATS Letter and NSX Letter.

16 Under the LLC agreements establishing the TRFs, FINRA (the "SRO Member") has sole regulatory responsibility for the TRF and the exchange, such as NSX (the "Business Member"), is primarily responsible for the management of the TRF's business affairs, including establishing pricing for use of the TRF, to the extent those affairs are not inconsistent with the regulatory and oversight functions of FINRA. Additionally, the Business Member is entitled to the profits and losses, if any, derived from the operation of the TRF and is responsible for any shortfall if the TRF cannot pay FINRA's regulatory charges.

17 NSX Letter.

These arguments are not germane to this filing. FINRA's charges for regulation of the TRFs are assessed pursuant to contract between FINRA and the respective TRF Business Members and are not subject to Section 15A(b)(5) of the Act. The fact that a TRF Business Member may determine that, for competitive reasons, the TRF should charge TRF participants a fee to generate revenues to cover some of the regulatory costs owed to FINRA under contract does not bring those regulatory costs within the scope of the Act. Any issue that NSX or the other TRF Business Members may have pertaining to FINRA's regulatory charges or the regulatory work FINRA performs is a matter of contract and cannot – and should not – be addressed through the rulemaking process.

One commenter further argues that if the SEC fails to require FINRA, as part of this filing, to demonstrate the reasonableness of the regulatory charges it imposes on the TRFs, members ultimately will be charged a fee that has never been subject to regulatory scrutiny.[18] However, the proposed rule change does not seek to modify FINRA's charges for regulation of the TRFs and, as noted above, those charges are a matter of private contract. With respect to fees that a TRF may charge its participants under FINRA rules, the proposed rule change does not propose to adopt or modify any such fees. Any proposed rule change to impose a fee on TRF participants would be filed with the SEC.[19]

Second, two of the commenters assert that the proposed rule change would be duplicative of FINRA's Order Audit Trail System ("OATS") requirements and FINRA has failed to explain why OATS cannot be relied upon for the information the non-tape reports would provide under the proposed rule change.[20]

OATS reporting currently is required only for Nasdaq-listed securities and OTC Equity Securities; it is not required for non-Nasdaq exchange-listed securities. Thus, FINRA does not receive OATS information for a large segment of transactions taking place in the OTC market today. In addition, while there is some overlap, OATS captures the life-cycle of an order, while the trade reporting rules are designed to capture information relating to executed trades. FINRA believes that the more logical place to require and house information regarding the parties to an executed trade is in the context of the trade reporting rules.

One of these commenters also asserts that it should be a "fairly easy exercise" to match the ultimate buyer and seller of a trade executed on an alternative trading

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18 BATS Letter.

19 See, e.g., Securities Exchange Act Release No. 57299 (February 8, 2008), 73 FR 8915 (February 15, 2008) (Notice of Filing and Immediate Effectiveness of SR-FINRA-2008-004).

20 Direct Edge Letter and BATS Letter.

system ("ATS") or electronic communications network ("ECN") using OATS execution reports.[21] However, FINRA rules do not mandate the submission of OATS reports in the manner described by the commenter and not all ATSs and ECNs report this way. Thus, the process of matching OATS execution reports is not as easy as the commenter suggests.

Third, one commenter asserts that FINRA has failed to justify its need for non-tape reports when FINRA can request information relating to the ultimate buyer and seller in a given transaction directly from the executing member.[22] This commenter argues that FINRA should be required to explain what has changed, either in the quality of the information it is receiving about transactions or in the regulatory requirements under which it is operating, that now makes the non-tape reports necessary or appropriate.

FINRA believes that the original filing adequately explains FINRA's need for the non-tape reports. As discussed in the original filing, FINRA trade reporting rules generally reflect the traditional two-party trade model where a broker-dealer acts as principal or as agent for a non-broker-dealer customer. Industry business models have evolved to include more trades where one broker-dealer acts as agent or riskless principal for another broker-dealer and order management systems and ATSs can simultaneously match one or more broker-dealer orders on one or both sides of a trade. Because the tape report generally only allows for the identification of two parties, where a FINRA member executes a trade in a riskless principal or agency capacity on behalf of another member, or matches, as agent, the orders of two or more members, the tape report does not identify all members involved in the trade and FINRA's audit trail is incomplete. The proposed rule change will enhance FINRA staff's ability to create a complete and accurate audit trail and assist in the automated surveillance of various customer protection and market integrity rules (e.g., for purposes of automated surveillance for wash sales, the audit trail must reflect the ultimate buyer and seller for any given transaction).

Fourth, one commenter requests that the SEC and FINRA defer consideration of this aspect of the proposed rule change to permit FINRA and the New York Stock Exchange ("NYSE") to collaborate with each other and the industry on a more uniform approach for regulatory reporting of riskless principal and agency trades.[23]

While FINRA does not dispute the value in harmonizing regulatory reporting requirements where possible, it is important to note that the proposed rule change and the new NYSE requirement cited by the commenter are not identical. The NYSE

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21 BATS Letter.

22 BATS Letter.

23 SIFMA Letter.

requirement relates to the mechanics of reporting riskless principal transactions effected on the NYSE by mandating the electronic linking of executions of facilitated orders to all underlying orders to qualify for an exception to NYSE Rule 92 (Limitations on Members' Trading Because of Customers' Orders). By contrast, the proposed rule change seeks to supplement the current information requirements for OTC riskless principal and agency reporting by requiring the identification of members on whose behalf the executing party is acting. FINRA does not believe that it is necessary to defer consideration of the proposed rule change in order to develop uniform riskless principal reporting requirements.

Finally, this commenter asks that if consideration of this aspect of the proposed rule change is not deferred, FINRA clarify the following points.

First, the commenter asks how the requirement to submit non-tape reports for "Manning" purposes will be reconciled with the proposed end-of-day submission of non-tape reports under the proposed rule change.[24] As explained in the original filing, although the 90-second reporting requirement would not apply to the submission of non-tape reports under the proposed rule change, in certain circumstances, members must submit non-tape reports contemporaneously with trade execution. For example, to qualify for the exemption from the requirements of NASD IM-2110-2 (the "Manning Rule") for riskless principal transactions, a member must submit, contemporaneously with the execution of the facilitated order, a non-tape report reflecting the offsetting "riskless" leg of the transaction.[25] For purposes of the Manning Rule, "contemporaneously" has been interpreted to require execution as soon as possible, but absent reasonable and documented justification, within one minute.[26] This is an existing requirement and it would not be affected by the proposed rule change. Thus, members should continue to report as they do today to qualify for the exemption under NASD IM-2110-2(c)(3).

Second, the commenter asks how the proposed rule change will impact the payment of Section 3 fees.[27] As stated previously, FINRA always bills the Section 3 fee to the clearing member identified as the sell-side on the tape report and does not take into account, for billing purposes, information relating to the parties to the trade that appears on a related non-tape report. Thus, the proposed rule change would have no impact on Section 3 fee billing.

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24 SIFMA Letter.

25 See NASD IM-2110-2(c)(3).

26 See NASD Notices to Members 95-67 (August 1995) and 98-78 (September 1998).

27 SIFMA Letter.

Third, the commenter asks whether the requirement to submit non-tape reports identifying all members involved in a trade would impact OATS matching requirements.[28] Under current FINRA rules, where an OATS execution report is related to a trade report (either tape or non-tape) submitted to a FINRA Facility, the OATS report must match to the related trade report. This requirement would apply to any non-tape report submitted under the proposed rule change.

Proposed Implementation

In the original filing, FINRA proposed that the implementation date of the proposed rule change would be at least 90 days from the date of SEC approval for transactions executed on ATSs (including ECNs) and at least 180 days for all other transactions. The commenters raise the following issues with respect to implementation.

One commenter (an ECN) objects to the shorter implementation period for ATSs and asserts that FINRA has failed to justify this approach.[29] Another commenter (also an ECN) states that it does not object to the shorter period for ATSs.[30] A third commenter requests that certain ATSs be permitted to comply with the later of the two dates in light of the systems changes they would be required to make (e.g., an ATS that trade reports and identifies its subscriber as the reporting party or has its subscriber report the trade, or an ATS that does not submit non-tape reports today).[31] This commenter also requests clarification that the shorter period applies only to systems that qualify as exchanges under the Act and operate under Regulation ATS. In response to these comments, FINRA is proposing to implement the proposed rule change on the same date for all members, including ATSs. The implementation date will be at least 180 days from the date of SEC approval.

In addition, one commenter requests that the implementation period not commence until after publication of revised technical specifications.[32] FINRA does not believe that the proposed rule change will result in any significant changes to applicable technical specifications. Members will continue to populate and submit to FINRA tape and non-tape reports in the same manner as they do today. Therefore, FINRA does not believe that the implementation date needs to be linked to the publication of technical specifications.

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28 SIFMA Letter.

29 Direct Edge Letter.

30 BATS Letter.

31 SIFMA Letter.

32 SIFMA Letter.

Finally, one commenter suggests that the non-tape reporting proposal be implemented approximately six months following implementation of the executing party trade reporting structure.[33] However, this commenter does not explain why the systems changes necessary to comply with both aspects of the proposed rule change cannot be made and tested simultaneously. FINRA believes that the proposed minimum 180 days should provide sufficient time for members to make all necessary systems changes. Therefore, FINRA is not proposing to extend the implementation period for the non-tape reporting proposal.

If you have any questions, please contact me at (202) 728-8190 or Stephanie Dumont at (202) 728-8176.

Very truly yours,

Lisa C. Horrigan
Associate General Counsel

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33 SIFMA Letter.