MEMORANDUM

TO: File No. SR-FINRA-2009-077

FROM: The Division of Trading and Markets

DATE: April 8, 2011

RE: Staff Meeting with Representatives of OTC Markets Group, Inc.

On March 8, 2010, staff of the Division of Trading and Markets met with Cromwell Coulson, OTC Markets Group, Inc., and Neal Sullivan and Michael Trocchio, Bingham McCutchen LLP to discuss FINRA's rule proposal relating to the restructuring of quotation collection and dissemination for OTC equity securities. OTC Markets provided the attached document outlining issues related to FINRA's proposal.

BINGHAM

Memorandum

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DATE: March 8, 2010

TO: James Brigagliano, Deputy Director
David Shillman, Associate Director
Nancy Sanow, Assistant Director

CC: Cromwell Coulson, Pink OTC Markets, Inc.

FROM: Neal E. Sullivan
Michael Trocchio

RE: **Outline of Issues Relating to FINRA's "QCF" Proposal**

I. INTRODUCTION

Pink OTC Markets, Inc. ("Pink OTC") believes the U.S. Securities and Exchange Commission should reject FINRA's rule filing seeking to create a Quotation Consolidation Facility (''QCF'') for over-the-counter ("OTC") equity securities (the "QCF Proposal").[1] The QCF Proposal lacks a satisfactory basis under the Securities Exchange Act of 1934 (the "Exchange Act"), and in fact is contrary to the provisions and purposes of the Exchange Act because, among other reasons, the QCF Proposal would: 1) harm the capital formation process by discouraging market making in the securities of small issuers, 2) harm transparency, liquidity, and execution quality to the detriment of investors, and 3) discourage competition among interdealer quotation systems and among market data vendors.

Furthermore, Pink OTC is not opposed to a consolidated quotation for OTC equities, but there is no practical need for FINRA to establish the QCF because consolidated quotes for OTC equity securities are already available through Pink OTC and other market data vendors. Finally, there is no regulatory oversight/surveillance advantage provided by the QCF Proposal because FINRA already receives all OTC equity quotation data under current regulatory requirements. In light of these deficiencies, the comments received by the Commission on the QCF Proposal have been universally negative, including comment letters from NASAA, SIFMA, the Security Traders Association, the Security Traders Association of New York, the U.S. Chamber of Commerce, and

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[1] *See,* Exchange Act Release No. 60999 (Nov. 13, 2009), 74 Fed. Reg. 61183 (Nov. 23, 2009).

leading market makers Knight Equity Markets, LP and E*TRADE Capital Markets, LLC.

II. THE QCF PROPOSAL

- The QCF Proposal would:
    1) require FINRA members to submit all their quotations in OTC equities to the QCF contemporaneous with such members' display of quotations in any interdealer quotation system that permits updates on a real-time basis;
    2) require a member that is an alternative trading system ("ATS") to submit contemporaneously to the QCF its "top of book;"
    3) enable FINRA to publish this quotation information as part of the NASDAQ Level One quotation data;
    4) permit FINRA to cease operation of the OTC Bulletin Board Service ("OTCBB"); and
    5) permit FINRA to charge members $4.00 per month for each security that they quote in the OTC markets (currently FINRA members pay no fees to FINRA in connection with their OTC equity quoting activities, except in the small minority of instances where they quote on the OTCBB).

III. PINK OTC MARKETS AND THE OTCBB

- Pink OTC operates one of the two real-time, interdealer quotation systems in the U.S. (FINRA operates the other, the OTCBB).
- Pink OTC's primary business is providing broker-dealers with an electronic interdealer quotation system to display quotes in OTC equity securities to other broker-dealers.
- Pink OTC also sells its quote data, consolidated along with OTCBB data that Pink OTC purchases from FINRA, to market participants such as broker-dealers, investment advisors, and securities information services such as Bloomberg and Reuters.
- Pink OTC currently delineates OTC equity securities that are quoted in Pink OTC into two tiers:
    1) OTCQX, the quality controlled premium tier where issuers meet specified financial, disclosure, and other standards as verified by an attorney or U.S. broker-dealer; and
    2) Pink Sheets, the tier where all non-OTCQX issuers are quoted.
- The OTCBB has not been competitive with Pink OTC:

  - 75 issues are quoted only on OTCBB, 5900 issues are quoted only in Pink OTC, and 3800 issues are quoted in both [approximate figures per FINRA's rule filing for the QCF Proposal];
  - Securities dually-quoted on Pink OTC and the OTCBB represented approximately 15% of 2009 total dollar volume of OTC trading in 2009 while securities only quoted on Pink OTC represented 85% (trading volume of OTCBB only securities is negligible); and
  - Pink OTC has 81,000 average broker-dealer quote positions compared to 23,000 on the OTCBB (OTCBB quote positions have declined 50% in the last few years and are continuing this decline).
- Rather than operate the OTCBB in competition with Pink OTC (akin to how FINRA's alternative display facility provides an alternative to displaying quotes on the exchanges), FINRA is shuttering the OTCBB.

IV. EXCHANGE ACT ISSUES REGARDING THE QCF

- **<u>The legal standard for SRO rulemaking has not been met.</u>**
  - Section 19(b)(2)(B) of the Exchange Act provides that "[t]he Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding."
  - Section 3(f) of the Exchange Act provides that "whenever pursuant to this title the Commission is engaged in ... the ***review of a rule of a self-regulatory organization***, and is required to consider or determine whether an action is ***necessary or appropriate in the public interest***, the Commission shall also consider, in addition to the protection of investors, whether the action will promote ***efficiency, competition, and capital formation***."
  - Contrary to Sections 19(b)(2)(B) and 3(f), the QCF Proposal will discourage ***competition*** among market data vendors because it will grant a ***monopoly to FINRA*** with respect to commercially valuable market data and discourage, and perhaps completely prevent, other market data vendors from entering the market to provide a consolidated NBBO in OTC equity securities. If the Commission wishes to enhance distribution of OTC equity quotation information, the Commission should takes steps to encourage competition among market data vendors and not eliminate competition by granting FINRA a monopoly.
  - Contrary to Sections 19(b)(2)(B) and 3(f), FINRA's QCF Proposal is ***not in the public interest*** nor consistent with the requirements of the

Exchange Act because it ***hinders capital formation*** by discouraging quoting by broker-dealers by measurably increasing the costs of quoting OTC equity securities. We believe that the QCF Proposal will significantly increase the cost of quoting OTC equities, both through FINRA's proposed "per quote" charge and an expected increase in fees charged by any interdealer quotation system to offset the loss of the revenue it could have earned from distributing quotation data. The increase in costs can reasonably be predicted to cause broker-dealers to quote fewer issues (*i.e.*, broker-dealers will stop quoting the least active issues as the costs to quote are outweighed by revenue from transactions), and issuers without a public market have less access to capital.

- Contrary to Sections 19(b)(2)(B) and 3(f), the QCF Proposal will discourage ***competition*** among interdealer quotation systems by discouraging competitors to Pink OTC from entering the market because one of the primary revenue streams of an interdealer quotation system (sale of quotation data) has been usurped by FINRA.

- **There is no legal requirement in the Exchange Act for the QCF.**
  - FINRA cites Exchange Act Section 15A(b)(6) and (11) as justification for the authority to create the QCF.
  - **Section 15A(b)(6)** requires FINRA to adopt rules to "**prevent fraudulent and manipulative** acts and practices" and "to promote **just and equitable** principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities."
  - **Section 15A(b)(11)** requires FINRA to **promulgate rules "governing the form and content of quotations** relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied."
  - NOTHING in these sections requires or even suggests that FINRA should be consolidating OTC equity quotes, and they cannot fairly be read to imply that FINRA *itself* has authority to collect, distribute, and publish quotations commercially in competition with and to the detriment of the private sector. In particular, Section 15A(b)(11) merely permits FINRA to establish rules governing the form and content of OTC quotes. Further, there appears to be no aspect of the QCF Proposal that prevents fraudulent and manipulative acts and practices nor that promotes just and equitable principles of trade in accordance with Section 15A(b)(6). While Section 15A(b)(6) does

permit FINRA to adopt rules that "foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities," the QCF Proposal does not foster such cooperation or coordination, rather, it installs FINRA as the monopoly coordinator of the collection and distribution of quotation data.

- **The QCF imposes an unpermitted burden on competition.**
  - **Section 15A(b)(9)** provides that FINRA's rules may "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title."
  - The QCF is anti-competitive because it denies FINRA members the benefits of a competitive environment for interdealer quotation services in the market for OTC equity securities. The QCF Proposal would require FINRA members to provide data for FINRA's own commercial use and increase quotation position fees for securities that broker-dealers currently quote in FINRA's competitor, Pink OTC. The increase in fees will cause fewer quotes to be published and discourage the entry of interdealer quotation systems into the marketplace.
- Where Congress has determined that is **it necessary and appropriate** for FINRA to fill a role that would otherwise be accomplished by the private sector, the Exchange Act is quite explicit in defining this objective. Congress has not done this relative to OTC quotations.
  - Section 17B of the Exchange Act authorized FINRA to establish the OTCBB to provide a market for "penny stocks" at a time when there was no private electronic system that displayed real-time quotation information for penny stocks. However, FINRA does not have, and cannot purport to find, authority under Section 17B to establish the QCF.
  - The majority of quotation updates and dollar volume in Pink OTC-quoted securities takes place in American Depositary Receipts ("ADRs"), foreign ordinary shares, and preferred securities. In its QCF Proposal, FINRA acknowledges that a primary reason for the QCF is that "certain classes of securities that are not currently eligible by rule for quotation on the OTCBB have experienced significant growth in the recent past (*e.g.*, unsponsored ADRs)." None of these classes of OTC equity securities are "penny stocks;" therefore, Section 17B cannot support the QCF Proposal. FINRA can continue to maintain the OTCBB for "penny stocks" in order to satisfy the requirements of Section 17B if it so chooses.
- **Section 11A(b)(1)** of the Exchange Act entitles the Commission to regulate securities information processors, including permitting the

Commission to require the registration of entities that act as a securities information processor ("SIP").[2] By virtue of Pink OTC's distribution of consolidated OTC quotations, it is a non-exclusive SIP within the meaning of the Exchange Act that is not required to be registered as a SIP with the Commission.[3] However, under Section 11A(b)(1), the Commission has the authority to require Pink OTC to register as a non-exclusive SIP. If the Commission finds that Pink OTC's dissemination of a consolidated quotation for the classes of securities not "currently eligible by rule for quotation on the OTCBB" under Section 17B should be regulated in some way, the proper way to do this under the Exchange Act (and consistent with Congressional intent)[4] would be to require Pink OTC to register as a SIP rather than permitting FINRA to make rules in an area that Congress has left to the Commission.

V. PRACTICAL ISSUES

- The QCF Proposal is a **regulatory taking** of Pink OTC intellectual property for FINRA's financial gain. Pink OTC has invested heavily in improving its product which IS quote data. Pink OTC sells its quote data to third parties such as broker-dealers, investment managers, and market data providers such as Bloomberg and Reuters. **The QCF**

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[2] Section 3(a)(22)(A) of the Exchange Act defines the term "securities information processor" to mean "any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) ..."

[3] Section 11A(b)(1) states that "... a securities information processor not acting as the exclusive processor of any information with respect to quotations for or transactions in securities is exempt from the requirement to register in accordance with this subsection unless the Commission, by rule or order, finds that the registration of such securities information processor is necessary or appropriate in the public interest, for the protection of investors, or for the achievement of the purposes of this section."

[4] The Congressional Committee reviewing the 1975 Amendments to the Exchange Act believed that the Commission rather than SROs should have the power to regulate processors of market information, and distinguishes between the Commission's direct authority as granted in the Exchange Act, and its indirect authority with respect to overseeing SRO rulemaking (*See*, H.R. Rep. 94-29 at 31 (1975), stating that "In order to assist the Commission's efforts to establish and regulate a national market system, the [1975 Amendments] ... greatly expand the Commission's direct regulatory powers over the nation's trading markets. [S]ection 11A(b) would clarify the Commission's direct authority over processors of market information."

Proposal, unlike the existing market structure relative to quotation in NMS securities, does not share the revenue derived from the distribution of OTC quotations with the quotation venue from which it is derived (Pink OTC). If the SEC approves the QCF proposal, Pink OTC Markets will be the ONLY quotation venue that is NOT COMPENSATED for the market data it contributes to the national market systems plans.

- There is no additional benefit to the market in terms of market data as **Pink already disseminates consolidated OTC equity quote data** reflecting the quotes on the OTCBB, Pink OTC, and the only ATS operating in this space, ARCA Edge.
- There is **no regulatory surveillance and oversight benefit** because Pink OTC has for years and continues to provide FINRA with real-time quotation data for surveillance purposes. Furthermore, FINRA, in addition to the quotation data supplied by Pink OTC, already has the complete audit trail via the OATS information reported by the broker-dealers effecting the transactions.
- The QCF Proposal **harms liquidity and transparency** by increasing costs on broker-dealers who quote and will discourage quoting in less liquid securities to avoid costs (FINRA already has a Transaction Activity Fee (TAF) to fund regulation which transactions in OTC equity securities constitute a substantial percentage of). The result of this decreased liquidity and transparency would be decreased capital formation by small issuers and worse execution quality for investors.
- Distribution of all OTC equity quotes as part of NASDAQ Level 1 may be misleading to investors (it suggests some level of oversight and/or quality of the companies being quoted that MAY not exist).