OTC Markets

May 7, 2012

**VIA Electronic Submission**

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **File No. SR-FINRA-2011-058; Release No. 34-66819**

Dear Ms. Murphy:

OTC Markets Group Inc. ("OTC Markets Group")[1] respectfully submits the following comments in response to the amended proposal by FINRA to amend FINRA Rule 6433 (Minimum Quotation Size Requirements for OTC Equity Securities) (the "Amended Proposed Rule"). The Amended Proposed Rule seeks to change the effective quote increments of OTC securities by reducing tier sizes. Allowing for the display of smaller sized customer orders, combined with reduced size requirements for the display of principal quotes, will lead to less displayed liquidity. Continuous principal quotes are a significant factor in the OTC markets, and the damaging loss of liquidity related to the principal quote size reduction will negate the benefits from the display of smaller customer orders. This will cause substantial harm to overall liquidity and the efficient functioning of OTC markets.

## Introduction

Through the recently enacted Jumpstart Our Business Startups Act ("JOBS Act"), Congress and the President directed the Commission to conduct a study of the effects of decimalization, the practice of quoting in penny increments (the "Tick Size Study"). Specifically, the Commission is to study the impact of decimalization on the number of small and mid-sized company IPOs, the liquidity in secondary trading market for securities issued by those companies, and whether decimalization has removed the economic incentive for market makers to quote these securities. The Tick Size Study clearly demonstrates the concerns of Congress and the Executive branch, recognizing

[1] OTC Markets Group operates the OTC Link trading system ("OTC Link"), which is the largest electronic interdealer quotation system for broker-dealers to publish prices and negotiate trades in OTC equity securities. OTC Link allows broker-dealer subscribers (all of which are members of the Financial Industry Regulatory Authority, Inc. ("FINRA")) to post quotes and communicate with each other regarding the execution of transactions. On March 5, 2012, OTC Markets Group's wholly-owned subsidiary, OTC Link LLC, was approved as a broker-dealer member of FINRA. On April 27, 2012, OTC Link LLC filed an initial operations report on Form ATS with the Securities and Exchange Commission (the "Commission"), indicating that it will take over the operation of the OTC Link trading system and begin operating as an alternative trading system on June 1, 2012.

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that quote and trading rules designed to govern transactions in securities of the largest issuers may not be appropriate when applied to trading in smaller, emerging companies with less active securities.

We recommend that the Tick Size Study be combined with an in-depth study of the potential effects of the Amended Proposed Rule on the OTC market. This would provide the type of data analysis that FINRA has failed to produce regarding the potential impact of Amended Proposed Rule, and would give effect to Congressional intent by ensuring significant economic analysis prior to instituting a change in the trading market for smaller company equity securities. OTC Markets Group conducted an internal analysis that reveals that the Amended Proposed Rule would negatively impact liquidity and volatility in the OTC market. Without the necessary level of analysis, FINRA and the Commission may impose a rule that erodes OTC market quality at a time when Congress and the Executive branch have made clear their concern over the health of this market.

In the Amended Proposed Rule, FINRA did not include any substantial analysis to support their revised proposed tiers. FINRA indicated that it amended its proposal in response to prior commenters, however despite our previous calls for in-depth study FINRA makes only a vague mention of data analysis relating to display of customer limit orders. The Amended Proposed Rule takes as a given that all OTC securities trading above $1.00 should conform to NMS tier sizes without providing any economic basis on the effect to liquidity. We are concerned that FINRA wants to blindly impose NMS rules on small companies at a time when Congress and the Executive branch have proposed studies to review and potentially change NMS rules as applied to the market for emerging companies.

Tier size, like tick size, is a method of creating price increments in the secondary trading markets. In our experience, where a security trading on the OTC market has a profile and trading pattern similar to a security trading on an NMS market, the OTC-traded security will often have more displayed liquidity, because the higher tier sizes in the OTC market lead to greater display of principal liquidity. It appears that the positive effects of the larger tier sizes in the OTC market have mitigated the negative impact of decimalization about which Congress has expressed its concern. Based on this reasoning, it is logical to conclude that the inextricably linked issues of tick size and tier size should be studied together. The JOBS Act mandated Tick Size Study provides an ideal opportunity for this type of joint analysis, which would benefit the OTC and NMS trading markets.

Without in-depth economic and academic study, the Amended Proposed Rule is not yet ready to be introduced in a pilot program. The potential risk to the OTC market posed by the Amended Proposed Rule outweighs the potential benefit to be gained by instituting a pilot, particularly a pilot as broad and lengthy as that proposed by FINRA. The chief benefit of the pilot, which would be the generation of practical data with which to assess the rule's effect, can be realized, with significantly less risk to the market, by conducting a study using currently available data. Only after there has been an appropriate analysis with publicly available data should any pilot program commence.

We propose a novel approach to help protect proprietary liquidity in the OTC market. Currently, a broker-dealer is prohibited from proprietary trading in a security at a price equal to or better than an unexecuted customer limit order in that security, even where the broker-dealer's proprietary quote is displayed prior to receipt of the customer limit order. Our proposed modification would allow the broker-dealer and the customer in this situation to trade in parity when the broker-dealer principal quote has set the price level. That is, the principal quote and the customer quote could trade in proportion to their displayed liquidity when the broker-dealer received the customer order. For example, where the broker-dealer quotes 500 shares, and the customer limit order is for 1,500 shares, the customer would take 75% of the resulting trade, and the broker-dealer could take the remaining 25%. This solution would incentivize proprietary liquidity and protect customer limit orders.

OTC Link facilitates trading in over 10,000 OTC securities, a majority of which are small and mid-sized emerging companies. OTC Link is by far the largest platform for the secondary trading of these smaller companies by broker-dealers, which gives us insight into how market structure promotes liquidity and efficiency. With approximately 160 FINRA member broker-dealers quoting OTC securities on our platform, we are constantly evaluating the needs of the OTC trading community.

As the operator of the principal platform for broker-dealers trading OTC equity securities, we endorse the Congressional intent behind the Tick Size Study, and we remain troubled by the apparent lack of thoughtful, comprehensive study given to the Amended Proposed Rule. We agree with Congress that an efficient market for the trading of the securities of smaller companies will sometimes require specially tailored rules, designed after appropriate economic and academic study.

**Background**

OTC Markets Group submitted four comments regarding the tier size rule originally proposed by FINRA in October 2011 (the "Original Proposed Rule"). Each comment expressed our view that FINRA did not adequately study the potentially harmful effects of the Original Proposed Rule on the quality and efficiency of the OTC market. We first commented in a letter dated November 10, 2011, noting that FINRA's analysis in support of the Original Proposed Rule was flawed and misleadingly simplistic. On November 18, 2011, we contacted, via email, economists in the Commission's Division of Risk, Strategy, and Financial Innovation requesting an economic review of the statistical analysis offered by FINRA in support of the Original Proposed Rule. A copy of that email was published as a comment to the Proposed Rule.

On December 29, 2011 we submitted a formal comment letter questioning the data analysis set forth by FINRA in support of the Original Proposed Rule and presenting the results of our own statistical analysis. In the December 29, 2011 letter, we reviewed data relating to all trades in OTC equity securities on October 27, 2011, which was the highest volume day during that month, and determined that the Original Proposed Rule would harm liquidity and impose direct costs on many investors.

Finally, on February 14, 2012, we submitted a comment in support of the Commission's Order Instituting Proceedings to Disapprove the Original Proposed Rule. In that letter, we again expressed our concern over the lack of substantive analysis done by FINRA in relation to the Proposed Rule. In conjunction with the February 14, 2012 letter, we provided for Commission study a compilation of quote and trade data on our platform for the month of October 2011.

**Effect of the JOBS Act, and its Application to the Amended Proposed Rule**

The JOBS Act seeks to speed the growth of the job market by easing the burden on capital raising faced by small and emerging companies, and recognizes that capital raising will be assisted by, among other things, ensuring that securities sold by emerging companies have an efficient and liquid secondary trading market. The Tick Size Study will play a significant role in creating the type of market structure Congress seeks in order to improve liquidity for emerging companies.

The JOBS Act allows the Commission to take action to improve the efficiency of the markets based on the results of the Tick Size Study. If the Commission concludes that securities of emerging companies should be quoted and traded at increments greater than one penny, it may put forth a rule designating a minimum quote increment for these securities of up to ten cents. The Commission's ability to take action to remedy potential inefficiency speaks to Congress' acknowledgment of the value of Commission rulemaking.

The JOBS Act should spur the Commission to conduct similar analysis on all proposed rules that may impact the market for the securities of growth companies, including the Amended Proposed Rule. The Commission's rulemaking process, with its allowance for public comment, gives the Commission the opportunity to solicit data from industry participants with the relevant expertise. With a staff of highly capable economists, and multiple academic studies from which to draw, the Tick Size Study can be combined with a study of the Amended Proposed Rule to identify the best policies for growing and maintaining an active, effective market for the secondary trading of smaller company equity securities.

To date, it appears FINRA has not conducted, or commissioned any qualified academics or economists to conduct, an analysis of the effects of the Original Proposed Rule or the Amended Proposed Rule on liquidity and volatility. In the Amended Proposed Rule release[2], FINRA notes that it randomly studied 100 million trades to determine the Amended Proposed Rule's impact on display of customer limit orders. We do not dispute FINRA's findings on this topic, but we remain extremely disappointed

[2] Release No. 34-66819; File No. SR-FINRA-2011-058, at Note 14.

that FINRA has not taken the next logical step in its analysis and conducted a study of how the Amended Proposed Rule is likely to affect overall liquidity in the OTC market.

OTC Markets Group's internal review revealed that with the Amended Proposed Rule, approximately 51% of the securities with priced quotes on the OTC Link platform would suffer considerable reductions in liquidity. Many of the affected securities would stand to lose more than 50% of their current displayed liquidity, as reduced tier sizes would remove sizeable amounts of proprietary liquidity from the market. As we have noted in prior comment letters, broker-dealers providing proprietary liquidity are highly likely to display quotes at the minimum tier size required. As tier sizes are reduced, broker-dealer proprietary quotes reduce accordingly, and the primary engine of liquidity on the OTC market suffers significant losses that will not be recouped through increased display of customer limit orders.

Prior to a Regulation NMS-principled rule being applied to the OTC market, the rule's effect on efficiency, competition and capital formation should be subject to economic analysis. It continues to appear as though FINRA's rule proposals are driven entirely by lawyers that have not solicited the input of qualified academics and economists that can adequately assess the effects of the proposed rules in this unsteady economic climate. The Tick Size Study should include a review by the Commission's economists in the Division of Risk, Strategy and Innovation, and such a study could incorporate an analysis of the effects of the Amended Proposed Rule.

Independent academics and economists have conducted previous tick size studies relating to smaller, less active stocks, and determined that smaller price increments have not reduced average trading costs.[3] In fact, scholars have recommended a move to higher minimum tick sizes in less active securities.[4] With the JOBS Act, Congress has again noted the important role significant data analysis should play in the design of and regulation of efficient markets for smaller company securities. William Christie, the noted scholar that lead the prior tick size studies, remains an excellent candidate to lead the JOBS Act's Tick Size Study as well as a study of the Amended Proposed Rule.

We have yet to receive a response from the Commission or FINRA related to the data we provided in connection with our February 14, 2012 letter. That data, along with the significant additional information available to the Commission and FINRA, would provide the basis for a comprehensive economic review of the potential effects of the Amended Proposed Rule, and may be beneficial to the Tick Size Study as well. OTC Markets Group would be happy to provide any additional data needed to complete either analysis.

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[3] See W. Christie, J. Harris and E. Kandel, "Tick Size, Market Structure and Trading Costs," *Stock Market Liquidity*, Chapter 10, 2008.
[4] See William G. Christie, *A Minimum Increment Solution*, Traders Magazine, October 2003, available at http://tradersmagazine.com/issues/20031031/1743-1.html?pg=1

## FINRA's Proposed Pilot Program

FINRA proposed implementing the Amended Proposed Rule through a "pilot program" that would last for one year and would apply to all OTC Equity Securities quoted on an interdealer quotation and messaging system. In practice, that would expose the entire OTC equity trading market to the potential negative effects of the Amended Proposed Rule, without any recourse for one year. Given the risks we have noted in the Amended Proposed Rule, the data gathered by FINRA's proposed pilot program could come at a great price.

Rather than rushing to implement a pilot program that could cause substantial damage to the OTC trading market, we urge FINRA and the Commission to gather the appropriate academics and economists to conduct the type of study for which we have been calling since the original Proposed Rule release. If, after carefully reviewing the results of such a study, the Commission believes the Amended Proposed Rule is likely to benefit efficiency, competition and capital formation, we recommend instituting a modified pilot program that runs for 3 months.

## Trading in Parity

The current ban on broker-dealers trading for their proprietary interest in a security when they receive a customer limit order in the same security, at the same price, reduces the incentive for broker-dealers to display proprietary quotes at prices in which they have orders. In effect, broker-dealers principal liquidity is instantly disadvantaged the moment they receive an order from a customer. Our prior comment letters regarding the Proposed Rule discussed at length the value of proprietary liquidity to the OTC market. In the Amended Proposed Rule, FINRA made a minimal effort to protect proprietary liquidity, apparently without formally researching the Amended Proposed Rule's probable negative effect on proprietary liquidity. The Amended Proposed Rule, while offering some improvement over the Proposed Rule, would still lead to broker-dealers reducing their proprietary quote activity in line with the new, lower tier size minimums. Based on our internal evaluation, the tier size reductions in the Amended Proposed Rule may still lead to the loss of 50% or more of the proprietary liquidity in securities priced between $.20 and $1.00.

OTC Markets Group is proposing a solution that would bolster proprietary liquidity in the OTC market. When a broker-dealer displays liquidity in a security and subsequently receives a customer limit order in that security at a price equal to the firm's proprietary quote, the broker-dealer should be permitted to trade "in parity" with its customer. In other words, the broker-dealer and customer should each be represented by a proportional amount of the broker-dealer's initial proprietary quote. This would incentivize broker-dealers to continue providing valuable proprietary liquidity while also giving effect to, and ensuring the display of, customer limit orders.

**Conclusion**

OTC Markets Group respectfully requests that in light of the Congressional intent demonstrated by the JOBS Act, the Commission take the initiative to combine the Tick Size Study with a thorough, economic analysis of the effects of the Amended Proposed Rule on the OTC market. With the JOBS Act, Congress and the President have made clear their desire for adequate study of the economic impact of policy changes in the secondary trading markets of America's small and mid-sized companies. A full and complete analysis of the OTC quote and trade data for the month of October 2011, previously provided to the Commission by OTC Markets Group, seems the appropriate places to begin such a study.

The Amended Proposed Rule improves on some facets of the original Proposed Rule, however the Amended Proposed Rule does not go far enough to protect liquidity and reduce volatility in the OTC market. Without significant economic and academic study, implementing a one-year pilot program applicable to all OTC Equity Securities displayed on an interdealer quotation system would subject the OTC market to sizeable risk without any corresponding benefit. The data exits for FINRA and the Commission to conduct appropriate study without burdening the OTC market with unwarranted risk.

Finally, it is clear that FINRA does not place appropriate value on the liquidity that proprietary trading provides to the OTC market. Our proposed "trade in parity" solution, which would apply only when proprietary liquidity is displayed prior to receipt of a customer limit order, would incentivize proprietary quoting in the OTC market. Regardless of the Commission's final determination on the Amended Proposed Rule, the "trade in parity" solution would benefit all OTC market participants.

Please contact me if you have any questions or require any additional information.

Very truly yours,

Daniel Zinn
General Counsel
OTC Markets Group Inc.

CC: Hon. Mary Schapiro, Chairman
Hon. Luis Aguilar, Commissioner
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