December 29, 2011

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. 34-65568**

Dear Ms. Murphy:

OTC Markets Group Inc., ("OTC Markets Group") a financial information and technology services company, operates OTC Link, an electronic interdealer quotation system in the United States OTC securities market that enables its 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. OTC Link LLC, a wholly-owned subsidiary of OTC Markets Group, has applied for FINRA membership. OTC Markets Group has informed FINRA that it intends for OTC Link LLC to operate the OTC Link interdealer quotation system as an Alternative Trading System ("ATS").

OTC Markets Group respectfully submits the following comments in further response to the filing of the proposal by FINRA to amend FINRA Rule 6433 (the “Proposed Rule”). The Proposed Rule would generally reduce the minimum quotation size requirements for firm quotations entered into interdealer quotation systems.

Background

We originally commented on the Proposed Rule in a letter dated November 10, 2011. On November 18, 2011, we contacted economists in the Division of Risk, Strategy, and Financial Innovation at the Securities and Exchange Commission (“SEC”) requesting an economic review of the statistical analysis offered by FINRA in support of the Proposed Rule. On November 30, Marc Menchel, FINRA’s Executive Vice President and General Counsel for Regulation, responded directly to SEC staff (the “Menchel Email”), arguing against certain points raised in our letter and that of another commenter, and expressing strong opposition to the SEC staff’s decision to engage our request for further economic analysis. On December 21, FINRA, in a letter by a member of Mr. Menchel’s staff, submitted a more formal response to all prior comments (the “FINRA Letter”), echoing many of the positions taken in the Menchel Email.

We commend the SEC staff’s commitment to transparency, evident in its publication of the Menchel Email. Public disclosure of the Menchel Email allows market participants to understand the full scope of FINRA’s views on, and understanding of the issues raised in, the Proposed Rule. That candid information sharing facilitates an open

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discourse regarding FINRA's basis for rulemaking and ultimately leads to a more effective public comment process. Soliciting information from public comments is an essential tool when evaluating any rule proposed by a self-regulatory organization ("SRO").

The Menchel Email states "In this case, two commenters make unsupported, at points unrelated and somewhat vague comments that on their face raise questions and one of the commenters ask[*sic*] the Commission to do the commenter's homework. After all, no SRO is required to undertake an economic analysis of its rule proposals, but it is charged with not burdening competition with rules that are not in furtherance or in conformity with the Securities Exchange Act. FINRA takes that charge very seriously. Nonetheless, there is no statutory or Exchange Act Rule requirement to undertake an economic analysis because a commenter makes such demand and we are unaware of any requirement on the part of the Commission to oblige such commenters. Rather, it would seem that commenters should bear some burden beyond naked assertions that a rule would have a deleterious effect when those assertions are neither supported by reasoned argument and/or devoid of factual data."

We are heartened to hear FINRA's commitment to proposing rulemaking that will not burden competition, but we believe the sentiment expressed in the Menchel Email and repeated in the FINRA Letter is misguided. Both the email and the letter cite the Securities Exchange Act of 1934 (the "Exchange Act"), however, neither mentions Section 3(f), which clearly requires the SEC, when reviewing an SRO rule, to consider whether the rule will promote efficiency, competition, and capital formation.[1] It is impossible to meet these straightforward requirements without adequate analysis by economists, academics and market structure professionals.

We are disappointed that Mr. Menchel chose to describe our comment and that of another commenter as "vague," "unsupported," "naked assertions," and "neither supported by reasoned argument and/or devoid of actual fact". We are equally frustrated by the assertion in the FINRA Letter that our comment "submitted on the last day of the comment period . . . appears to have been designed to prolong or even halt the rulemaking process." To the contrary, both our initial comment and this letter are intended to ensure that the SEC and FINRA are well aware of the various potential consequences of the Proposed Rule, rather than blindly instituting another NMS-principled rule in the OTC market. Despite the protest raised in the FINRA Letter, when FINRA proposes to apply an NMS rule to the OTC market, it is unquestionably relevant for a commenter to point out that the application of such rules may not be appropriate for the types of securities and level of trading activity in the OTC marketplace. We again note that FINRA's consistent desire to bring NMS rules to the OTC market ignores the fact that NMS rules are principally designed for widely followed, actively

[1] "whenever . . . 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."

traded securities, with much greater depth of order books and liquidity than is typically true of OTC securities. Because of the difference in types of securities traded, liquidity and trading velocity, the NMS and OTC marketplaces have not always operated in exactly the same manner. Often, this has been to the benefit of investors.

While we have never had the opportunity to discuss OTC market structure or this rule change with Mr. Menchel or his staff, we would hope that when undertaking a thoughtful analysis of the Proposed Rule, they would find beneficial our comments as well as the input of a significant FINRA member firm such as Knight Capital Group, the largest provider of trade executions in OTC equity securities. Instead, the FINRA Letter chose to embrace the support of two commenters[2] that appear, at best, uninformed. The FINRA Letter citing this "support" appears to be a thinly veiled effort to convince the SEC that the public supports the Proposed Rule.

FINRA's senior management callously dismissing informed industry commenters raises the question of whether the organizational culture of FINRA has the appropriate "tone at the top" to promote rulemaking that meets FINRA's statutory obligations regarding efficiency and capital formation. Historically, the NASD had an OTC Bulletin Board Committee for OTC trading that included FINRA member firms and industry experts, however it has been dissolved under Mr. Menchel's watch. We invite Mr. Menchel and his staff to re-open a more friendly dialogue with us, member firms and other market participants regarding the potential impact of the Proposed Rule and other FINRA proposals on the OTC market, as we should share the goal of building a better marketplace.

We thank the SEC staff for supporting our request to undertake an economic review of the Proposed Rule. The SEC staff clearly takes seriously its mandate to ensure that SRO rules improve market structures for all types of securities. At times, fulfilling this mandate requires additional data-based research to determine whether a proposed rule is likely to produce a positive effect on markets and market participants while minimizing unintended negative consequences. Should the results of SEC's study conclusively determine that the Proposed Rule will benefit the OTC market, we will accept that determination. Our interest is in ensuring that FINRA implements regulation in the best interest of all OTC market participants, including investors. The SEC, its staff, and outside commenters should be encouraged to participate in the comment process by providing additional data, raising salient points, and, most importantly, asking questions regarding all aspects of proposed FINRA rulemaking.

Questions raised during the comment process are of the utmost importance, as many FINRA rules never undergo a substantive review of their effectiveness after they have been implemented. A robust comment process leads to efficient regulation, and, because all parties are included in the process, a less contentious relationship between FINRA and its constituency.

[2] Referred to in the FINRA Letter as the "Shatto letter," dated October 20, 2011 and the "Hamlet letter," dated October 21, 2011.

In our November 10 letter, we indicated that we planned to provide additional information and analysis relating to the potential effect of the Proposed Rule on the display of customer limit orders. In addition to the SEC economic review currently underway, we conducted our own study to better analyze the current quotation and trading activity and what it may mean for the efficacy of the Proposed Rule. We note that FINRA staffers have access to all of the information we reviewed, but have not chosen to do any additional analysis of quotation and trade data. We do not intend to repeat all of the arguments we made in our initial letter. Instead, we will present the results of our own statistical analysis and focus on the flawed statistical analysis that FINRA is using to support the Proposed Rule.

Changes to Limit Order Display and its Effect on Liquidity

FINRA's stated objective behind the Proposed Rule is to facilitate the publication of customer limit orders. While this may be a laudable goal, changing tier sizes is not guaranteed to automatically improve market liquidity and efficiency. The Menchel Email states: "The purpose of the filing could not be simpler: smaller quote sizes will allow for greater us [*sic*] of limit orders by investors." There is no simple change that will unearth a goldmine of small orders that were previously not displayed to the public while avoiding the reduction in size of every currently displayed order and quote. The marketplace does not react in the static manner that the Menchel Email and the FINRA Letter seem to expect. Instead, market participants will react dynamically based upon their best interests. For example, while some new, smaller orders will be displayed, this will be offset by the reduction in displayed size of many existing orders and quotes that currently drive the inside best bid offer. Ideally, tier sizes should be designed to create the optimum balance to maximize marketplace efficiency and capital formation.

Our concerns about changing tier sizes or quote increments are based on the following beliefs regarding the dynamic effects of reducing tier sizes:

1) Smaller sized investor limit orders and broker-dealer proprietary quotations will be able to effect the inside best bid offer.
2) Investor limit orders and broker-dealer proprietary quotations will be able to display a better price at a volume lower than the current minimum size, thus reducing size displayed on the inside.
3) Broker-dealer proprietary quotations will be able to display the same price at a share volume lower than the old minimum size, thus maintaining the best bid offer price spread but reducing the size displayed on the inside.
4) Market orders that are interacting with other investor orders will benefit if the lower tier sizes result in the display of liquidity currently not displayable based on existing rules.
5) Market orders that are interacting with proprietary quotations will be disadvantaged because lower tier sizes will result in a reduction of displayed broker-dealer proprietary quotations.

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6) Tighter spreads and larger size each encourage trading, while wider spreads and smaller size each negatively affect trading behavior.
7) Market orders benefit from increased market liquidity provided by broker-dealers publishing proprietary quotations, which add significant liquidity beyond that of investor limit orders.
8) Lower tier sizes will ultimately increase volatility due to less displayed liquidity, which will drastically disadvantage market orders at a share volume greater than tier size.

Price and size are equally important components of liquidity. Requiring a certain amount of liquidity to affect the best bid offer in a security incentivizes investor limit orders and broker-dealer quotations to reach the required size. Tier size requirements must cause enough limit orders to be displayed that they prevent the build-up of a significant amount of non-displayed liquidity at prices better than the displayed inside best bid offer, while also balancing the need attract sufficient dealer liquidity through market maker principal quotations. We hope the SEC staff's careful analysis of trading data provides FINRA the information needed to create balanced tier sizes that will maximize efficiency, competition and capital formation for the OTC traded securities.

OTC Markets Group Statistical Analysis

FINRA's analysis regarding a sample of data submitted into the Order Audit Trail System (OATS) indicates that only 50% of customer limit orders currently satisfy the minimum quotation sizes specified in Rule 6433, as compared to over 90% of customer limit orders under the Proposed Rule. OTC Markets Group does not have access to the data contained in OATS, but we believe FINRA's analysis is inaccurate and misleading. FINRA does not segment the order data by (i) market orders, (ii) marketable limit orders, (iii) limit orders that would have improved the spread of the best bid offer, (iv) limit orders at the best bid offer, and (v) limit orders outside of the best bid offer. FINRA also fails to analyze of the number of executions against limit orders and the number of executions involving a broker-dealer injecting liquidity by trading as a principal.

OTC Markets Group performed a study using information gathered via the OTC Trade Reporting Facility. We reviewed data relating to all trades in OTC equity securities on October 27, 2011, which was the highest volume day during that month. We chose the highest trading day of the month based on the premise that investor liquidity would have been highest on the most active day. Our study analyzed the share volume, dollar volume, and number of trades in relation to the tier sizes under current Rule 6433 and the tier sizes under the Proposed Rule.

Of the more than 87,000 trades on the date of the study, 99% of share volume took place at or above current tier sizes, leaving share volume below tier size at less than 1%. Using the tier sizes in the Proposed Rule, the share volume below tier size would fall slightly, to 0.38%. As for dollar volume, 95.5% of over $950 million was in trades at or above current tier size, with only 4.5% below tier size. Under the Proposed Rule, .08% of dollar volume would fall below tier size.

Taking a narrow view based solely on count, a total of 38% of trades were below tier size under current Rule 6433. Of the trades below tier size, a significant portion were likely market orders. If the Proposed Rule had been in effect on the date studied, 7% of trades would have been below tier size. With the Proposed Rule bearing on less than 1% of share volume and less than 5% of dollar volume, its ability to increase displayed liquidity through incentivizing additional, tiny limit orders is much more limited than FINRA indicated in its proposal. When actual trade data is analyzed, it is clear that the FINRA analysis is flawed and that a significant percentage of OTC share volume or dollar volume is not, in fact, currently undisplayed to the market.

The Proposed Rule would also impose a direct cost on investors, particularly investors placing marketable orders, in part due to a potential loss of liquidity. While FINRA aims to promote investor use of limit orders, it ignores the impact of the Proposed Rule on the reduced incentive to display size for broker-dealer proprietary quotes and some customer limit orders. Marketable orders -- market orders and marketable limit orders -- are filled by proprietary quotes, which are primarily published at the minimum tier size. Proprietary quote activity at current tier size provides an influx of displayed liquidity, which allows the vast majority of investors to trade efficiently.

Reducing tier sizes under the Proposed Rule would likely lead the vast majority of market makers to reduce their quote sizes and ultimately to display less liquidity. Existing limit orders would also suffer, as active traders would be incentivized to drop to the lower tier sizes required for display under the Proposed Rule. Smaller tier sizes also have the effect of reducing passive liquidity providers that create additional liquidity by competing at the inside price for investor executions, as the liquidity is based on a multiple of the inside size.

The Menchel Email questions another commenter's assertion that a reduction of mandatory quote sizes will cause market participants to reduce their quote sizes accordingly: "Knight avers that the proposal will reduce liquidity because of the reduction of mandatory quotes sizes and increase trading and clearing costs because more transactions will be needed to accomplish executions. On its face the comment letter is curious because it does not answer the question as to why market participants would reduce their quote size simply because the rule proposal provides that option but doesn't mandate smaller quote sizes; especially if it is uneconomic to market participants to process smaller size orders." While we cannot speak to the specific decision making process of each market maker and investor, we strongly agree with the Knight comment based on discussions with market makers that subscribe to our services. Despite the personal beliefs of Mr. Menchel and other FINRA staffers, history strongly supports our reasoning. When mandatory quote sizes were lowered in NMS securities, the vast majority of proprietary quotes on NASDAQ were dropped to the new, lower tier sizes, which resulted in lost displayed liquidity for smaller companies. To borrow a phrase from the Menchel Email, it seems curious that FINRA would question the knowledge of a firm such as Knight when predicting how market makers will respond to a tier size rule change, especially when there is such a recent example that clearly supports the prediction.

In building the leading interdealer quotation system for the OTC market, we based our strategy on the beliefs that principal trading is an important component of a successful marketplace, and that broker-dealer proprietary quotes provide a significant amount of the displayed liquidity in the OTC marketplace. The OTC Markets Group study of quotation data shows that approximately 78%[3] of inside market quotes (combined bids and offers) published on our interdealer quotation system on October 27, 2011 were quoted at a share size equal to tier. This clearly indicates that tier size is a preferred size for the majority of market participants, and a new smaller tier size has a high probability of reducing the size displayed in the vast majority of inside quotes. As quote sizes drop to match the new tiers, the Proposed Rule will drastically reduce the amount of liquidity available at the inside. Our analysis of quotation data strongly indicates there is a significant risk that investors and liquidity will be harmed by the corresponding increase in trading costs and difficulty accessing liquidity if tier sizes are drastically lowered by FINRA and the vast majority of inside quotes have significantly lower sizes.

FINRA contends that the Proposed Rule would increase the number of displayed customer limit orders, and we believe that is correct. Taken independently, static analysis would say that the increase in displayed limit orders would increase liquidity, depending on investor response to the new tier sizes. However, when factoring in the dynamic nature of market participants, it seems likely that sizes displayed from proprietary market maker quotes and some existing limit orders will be reduced to correspond with the new, lower tier sizes. The extensive decrease in displayed proprietary liquidity will overwhelmingly offset the benefit of the increased number of customer limit orders displayed. This will lead to an overall decrease in available liquidity as a result of the Proposed Rule.

FINRA's Flawed Statistical Analysis

We believe that FINRA's simplistic analysis lacks the depth and context necessary to achieve credible results. Our initial comment letter addressed some of the problems with FINRA's study, however we feel it is appropriate to raise certain key issues again here.

Most glaringly, FINRA's analysis ignores its own rules, under which a market maker that receives customer limit orders is required to aggregate those orders for purposes of the limit order display rule. If the orders, as aggregated, would satisfy the minimum quotation requirements of Rule 6433 for a security, the market maker must publish the aggregated orders in any interdealer quotation system in which it is publishing quotations for that security. FINRA failed to take account of the aggregation requirement, and as a result its statistics are grossly inaccurate.

[3] There were 1,952,184 inside quotes received, of which 1,516,262 were at a share size equal to tier.

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The FINRA Letter takes exception to this argument, stating "[w]e find the suggestion that transparency of customer limit orders should be dependent upon the expectation that other customer limit orders in the same security will be placed at the same price and around the same time to be incorrect." The FINRA Letter misses the relevant point. Our concern regarding aggregation is not based on an expectation as to how customer limit orders will behave in the future, rather we believe that FINRA has provided misleading data by not taking into account the existing effect of aggregation on the numbers it is analyzing. It is not a question of making predictions; it is a question of presenting the correct factual data.

FINRA also failed to provide any information regarding dollar and share volume relative to tier size, choosing instead to focus only on a count of customer orders based on data derived from OATS. In addition, the FINRA study lacked any analysis of the type of orders it reviewed, giving no indication of the Proposed Rule's potential impact on market orders or proprietary quotes. The insight provided by a deeper look into the effectiveness of the current tier sizes indicates that the Proposed Rule is flawed as written.

With the faulty reasoning and simplistic analysis behind the Proposed Rule creating a strong potential for unintended consequences that will harm efficiency, competition and capital formation, we continue to believe that FINRA must address the clear risk of negative effects. The potential decrease in displayed liquidity caused by the Proposed Rule would substantially increase effective spreads and transaction costs for all investors.

The misguided reasoning expressed in the Menchel Email indicates a broader push towards creating an auction-type market structure that removes market makers from the trading process and dogmatically homogenizes market structure for every type of security into a central limit order book where investors' orders are executed without the participation of a dealer. The Menchel Email clearly expresses the sentiments that (i) market makers are not essential to ensuring competitive markets, and (ii) the NMS market model should be universally applied to the OTC market. We remind Mr. Menchel and other FINRA staffers that the opportunity for investor orders to interact with one another must be balanced with the need for economically efficient execution of securities transactions and fair competition between auction markets and dealer markets.

It should be noted that Congress has historically disagreed with FINRA's one size fits all stance, and has instead promoted competition among market structures. The Senate Committee on Banking, Housing, and Urban Affairs, when commenting on the 1975 proposal to establish a National Market System, reported that "In the Committee's view the fundamental goals of a national market system include (1) providing an investor or his broker with the ability to determine, at any given time, where a particular transaction can be effected at the most favorable price and (2) creating an incentive for multiple market makers to deal in depth on a continuous basis. In other words, in the national market system, investors should be able to obtain the best execution of their orders and be assured that because of open competition among market makers the total market for each security is as liquid and orderly as the characteristics of that security warrant."[4]

The above statutory mandate, ultimately codified in Section 11A of the Exchange Act, is also a good guideline for how to succeed as the operator of an interdealer quotation system. We have used that congressional intent as a roadmap for our own offerings in creating an open, transparent and connected platform that allows FINRA member broker-dealers to compete for the execution of investor orders. By providing an equal opportunity and fair access to our platform and market data for all types of broker-dealer business models, including market makers, agency brokers, electronic order books, and dark pools, we allow choice and competition to dictate market development. We hope that the SEC staff will ensure that this and other FINRA rulemaking will not favor certain broker-dealer business models or hinder the dynamic development of efficient and liquid OTC markets that foster both principal and agency trading.

Conclusion

OTC Markets Group respectfully requests that the Securities and Exchange Commission (the "Commission") withhold its final determination on the Proposed Rule until the Division of Risk, Strategy, and Financial Information completes its review of the actual net effect of the Proposed Rule. Pending the results of that economic study, we join with other commenters in suggesting that if the Commission is inclined to move forward with the Proposed Rule, it do so with a limited pilot program that can assess the impact of the Proposed Rule on market quality.

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 Aquilar, Commissioner
Hon. Daniel Gallagher, Commissioner
Hon. Troy Paredes, Commissioner
Hon. Elisse Walter, Commissioner

[4] S. Rep. 94-75, Securities Acts Amendments of 1975, Senate Report (Banking, Housing, and Urban Affairs Committee) April 14, 1975, at page 12.

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