

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62359; File No. SR-FINRA-2009-054)

June 22, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, to Establish in the Market for OTC Equity Securities Certain Regulatory Protections Derived from Certain Rules Adopted by the Commission in the Market for Listed Securities

I. Introduction

On August 7, 2009, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to establish certain regulatory protections for the market for OTC Equity Securities³ that are similar to those established for national market system securities by Regulation NMS.⁴ The proposed rule change was published for comment in the Federal Register on August 26, 2009.⁵ The Commission received 12 comments on the Initial Notice.⁶ On March 1, 2010, FINRA filed Amendment No. 1 to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See FINRA Rule 6420(d) (defining OTC Equity Security as “any non-exchange-listed security and certain exchange-listed securities that do not otherwise qualify for real-time trade reporting”). Pursuant to Securities Exchange Act Release No. 61979 (April 23, 2010), 75 FR 23316 (May 3, 2010), effective June 28, 2010, the term OTC Equity Security will be defined in FINRA Rule 6420(c) as “any equity security that is not an ‘NMS stock’ as that term is defined in Rule 600(b)(47) of Regulation NMS; provided, however, that the term “OTC Equity Security” shall not include any Restricted Equity Security.”

⁴ 17 CFR 242.600 et seq.

⁵ See Securities Exchange Act Release No. 60515 (August 17, 2009), 74 FR 43207 (“Initial Notice”).

⁶ See Submission via SEC WebForm from anonymous, dated September 1, 2009; Letter to Nancy M. Morris, Commission, from Janet M. Kissane, Senior Vice President – Legal and Corporate Secretary, NYSE Euronext, dated September 23, 2009 (“ArcaEdge Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Leonard J.

the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on March 16, 2010.⁷ The Commission received two comment letters in response to the Amended Notice.⁸ This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change

With this proposed rule change, FINRA proposes to establish certain regulatory protections for the market for OTC Equity Securities that are similar to those established for national market system securities by Regulation NMS. First, FINRA proposes to adopt Rule 6434 (Minimum

Amoruso, General Counsel, Knight Capital Group, Inc., and Michael T. Corrao, Chief Compliance Officer, Knight Equity Markets, L.P., dated September 16, 2009 (“Knight Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from William Assatly, Senior Vice President – Trading, Mercator Associates, dated September 16, 2009 (“Mercator Letter”); Letter from Daniel Kanter, President, and Craig Carlino, Chief Compliance Officer, Monroe Securities, Inc., dated September 16, 2009 (“Monroe Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets, Inc., dated September 23, 2009 (“Pink OTC Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets, Inc., dated January 6, 2010 (“Pink OTC 2 Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Ann L. Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated October 13, 2009 (“SIFMA Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Kimberly Unger, Executive Director, The Securities Traders Association of New York, Inc., dated September 14, 2009 (“STANY Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Kimberly Unger, Executive Director, The Securities Traders Association of New York, Inc., dated September 16, 2009 (“STANY 2 Letter”); Letter to Florence H. Harmon, Deputy Secretary, Commission, from Elaine M. Kaven, Chief Compliance Officer, StockCross Financial Services, Inc., dated September 16, 2009 (“StockCross Letter”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Christopher Nagy, Managing Director Order Strategy, Co-Head of Government Relations, TD Ameritrade, Inc., dated October 5, 2009 (“TD Ameritrade Letter”).

⁷ See Securities Exchange Act Release No. 61677 (March 9, 2010), 75 FR 12584 (“Amended Notice”).

⁸ See Letter from Daniel Kanter, President and Craig Carlino, Chief Compliance Officer, Monroe Securities, dated April 6, 2010 (“Monroe 2 Letter”); Letter to Elizabeth M. Murphy, Commission, from R. Cromwell Coulson, Chief Executive Officer, Pink OTC Markets Inc., dated April 9, 2010 (“Pink OTC 3 Letter”).

Pricing Increment for OTC Equity Securities) to impose restrictions on the display of quotes and orders for OTC Equity Securities in sub-penny increments similar to those in Rule 612 of Regulation NMS.⁹ Rule 6434 would prohibit members from displaying, ranking, or accepting from any person a bid or offer, order, or indication of interest in an OTC Equity Security in an increment smaller than \$0.01 if the bid or offer, order, or indication of interest is priced \$1.00 or greater per share. As initially filed, FINRA proposed to prohibit members from displaying, ranking, or accepting a bid or offer, order, or an indication of interest in an OTC Equity Security in an increment smaller than: (1) \$0.0001, if the bid or offer, order, or indication of interest were priced between \$0.01 and \$1.00 per share; and (2) \$0.000001, if the bid or offer, order, or indication of interest were priced less than \$0.01 per share.¹⁰ As discussed below, FINRA subsequently amended the proposal to prohibit members from displaying, ranking, or accepting from any person a bid or offer, order, or indication of interest in an OTC Equity Security in an increment smaller than \$0.0001 for bids, offers, orders, and indications of interest priced below \$1.00 per share. If an order or indication of interest is priced less than \$0.0001 per share, a member may rank or accept, but not display, that order or indication of interest in an increment of \$0.000001 or greater.

Second, FINRA proposes to adopt Rule 6437 (Prohibition from Locking or Crossing Quotation in OTC Equity Securities) to require that members implement policies and procedures that reasonably avoid the display of, or engaging in a pattern or practice of displaying, locking, or crossing quotations in any OTC Equity Security within the same inter-dealer quotation system. This is similar to Rule 610(d) of Regulation NMS.¹¹

⁹ 17 CFR 242.612.

¹⁰ See Initial Notice, 74 FR at 43207.

¹¹ 17 CFR 242.610(d).

Third, FINRA is proposing a new regulatory approach to fees for accessing quotations in OTC Equity Securities. FINRA is deleting its Rule 6540(c), which provides that an alternative trading system (“ATS”) or electronic communications network (“ECN”) must reflect non-subscriber access or post-transaction fees in the ATS’s or ECN’s posted quote in the OTC Bulletin Board montage. In addition, FINRA proposes to allow market makers – as well as ATSs and ECNs – to charge access fees. As a result, market makers, ATSs, and ECNs may charge access fees that are not displayed in the quotation. Simultaneously, however, FINRA proposes to adopt new Rule 6450 (Restrictions on Access Fees) that would establish a cap on non-subscriber access and post-transaction fees in all OTC Equity Securities, similar to Rule 610(c) of Regulation NMS.¹² Rule 6450 would provide that, if the price of the published quotation were \$1.00 or more, the fee or fees cannot exceed or accumulate to more than \$0.003 per share. As initially filed, if the price of the published quotation were less than \$1.00, the fee could not exceed 0.3% of the published quotation price per share. As discussed below, FINRA subsequently amended this portion of the proposal to provide that, if the price of the published quotation were less than \$1.00 per share, fees cannot exceed or accumulate to more than the lesser of 0.3% of the quotation price per share, or 30% of the minimum pricing increment under Rule 6434.

Fourth, FINRA proposes to adopt Rule 6460 (Display of Customer Limit Orders), similar to Rule 604 of Regulation NMS.¹³ Under Rule 6460, a market maker displaying a priced quotation in an inter-dealer quotation system would be required to immediately display a customer limit orders that it receives that (1) improves the price of the bid or offer displayed by the market maker; or (2) improves the size of its bid or offer by more than a de minimis amount, where it is

¹² 17 CFR 242.610(c).

¹³ 17 CFR 242.604.

priced equal to the best bid or offer in the inter-dealer quotation system where the market maker is quoting. Similar to Rule 604 of Regulation NMS, Rule 6460 excepts any customer limit order that (1) is executed upon receipt of the order; (2) is placed by a customer who expressly requests that the order not be displayed; (3) is an odd-lot order; (4) is a block size order, unless a customer placing such order requests that the order be displayed; (5) is delivered immediately upon receipt to a national securities exchange or to an electronic communications network that widely disseminates such order and complies with the Rule's provisions relating to such electronic communications network; (6) is delivered immediately upon receipt to another OTC market maker that complies with the proposed limit order display requirements with respect to that order; or (7) is an all-or-none order. In Amendment No. 1, FINRA proposed to add an exception for customer limit orders that are priced less than \$0.0001 per share, consistent with the revision to proposed Rule 6434 that allows a member to rank or accept, but not display, an order or indication of interest in an increment as small as \$0.000001, if the order or indication of interest is priced less than \$0.0001 per share.

FINRA also proposed to make conforming changes to certain of its other rules to reflect the establishment of these new rules.

III. Summary of Comments

The Commission received 12 comments regarding the Initial Notice¹⁴ and two comment letters regarding the Amended Notice. These comment letters are summarized below.

Contemporaneously with filing Partial Amendment No. 1, FINRA submitted a response to the comments on the Initial Notice.

¹⁴ See supra note 6.

Minimum Quoting Increments. One commenter supported this aspect of the proposal, stating that it would improve depth and liquidity in the marketplace by mitigating potential harms associated with sub-penny quoting, including “stepping ahead” of publicly displayed orders.¹⁵ Other commenters stated that sub-penny quoting may produce flickering quotes¹⁶ or result in increased quote traffic without providing any discernable benefit to investors.¹⁷

Other commenters disagreed with the proposal as it relates to minimum quoting increments. While one commenter supported restrictions on sub-penny pricing in theory, it stated that the minimum quoting increments for shares priced below \$1.00 per share were not “meaningful” increments.¹⁸ Another commenter argued that certain stocks priced above \$1.00 per share have benefited from the ability to trade in sub-penny increments, and that prohibiting sub-penny quoting could thus negatively impact the integrity of the OTC equity market.¹⁹ Two commenters stated that securities traded in sub-penny increments “have traded efficiently for decades,”²⁰ one of which added that FINRA had offered no empirical data to support its proposal.²¹

One commenter stated that the proposed minimum increments were still small, and would not prevent stepping ahead of customer orders or flickering quotes.²² Another commenter noted that the initially proposed price increment of \$0.000001 for stocks priced below \$0.01 per share

¹⁵ See TD Ameritrade Letter at 2.

¹⁶ See Pink OTC Letter at 8; STANY Letter at 2.

¹⁷ See STANY Letter at 2.

¹⁸ See Pink OTC Letter at 8.

¹⁹ See SIFMA Letter at 2.

²⁰ Mercator Letter at 1; see also Knight Letter at 2.

²¹ See Knight Letter at 2.

²² See ArcaEdge Letter at 2.

would create 10,000 price points below \$0.01, which could lead to “significant operational and market quality issues,” especially since most securities in the OTC equity markets trade at prices less than \$0.01.²³ Another commenter proposed that the minimum price increment for securities priced between \$0.10 and \$1.00 per share should be \$0.001, and that the minimum price increment for securities priced below \$0.01 per share should be \$0.0001.²⁴

Locked and Crossed Markets. Three commenters supported this aspect of the proposal.²⁵ One commenter stated that the proposal would lead to a more fair and orderly market, as it would enhance the usefulness of quotation information and decrease investor confusion.²⁶ Three commenters noted, however, that investors would be better served if the proposal were extended across all inter-dealer quotation systems, and not just within separate inter-dealer quotation systems.²⁷ One of these commenters stated that the duty to avoid locked and crossed markets should be co-extensive with the duty of best execution.²⁸

Two commenters stated that FINRA’s proposal was unlikely to actually prevent locked or crossed markets,²⁹ because market participants already make reasonable efforts to avoid locked or crossed markets,³⁰ and market participants most likely lock or cross the market to avoid paying access fees.³¹ One commenter supported FINRA’s efforts to reduce locked and crossed markets, but stated that this proposal did not provide any data to support a conclusion that locked

²³ See Knight Letter at 2.

²⁴ See ArcaEdge Letter at 2.

²⁵ See ArcaEdge Letter at 2; TD Ameritrade Letter at 2; STANY Letter at 2.

²⁶ See TD Ameritrade Letter at 2.

²⁷ See Pink OTC Letter at 6; STANY Letter at 2; TD Ameritrade Letter at 2.

²⁸ See Pink OTC Letter at 7.

²⁹ See Mercator Letter at 1; StockCross Letter at 2.

³⁰ See Mercator Letter at 1.

³¹ See Mercator Letter at 2; see also StockCross Letter at 2.

and crossed markets are occurring with sufficient frequency to impact market quality.³² Another commenter stated that the number of locked and crossed markets would increase if Rule 6450 were adopted and if the requirement to display access fees in the quote were eliminated.³³

Some commenters believed that the adoption of Rule 6450 would increase the incidence of locked and crossed markets resulting from “access-fee” trading.³⁴ One commenter noted that, since the proposed rule does not prohibit locking/crossing across inter-dealer quotation systems, market participants can lock or cross across markets, while receiving “an instant, virtually riskless profit” of the access fee.³⁵

Limit Order Display. Three commenters endorsed proposed FINRA Rule 6460.³⁶ One of these commenters stated that investors “gain enormous benefits of added transparency when market centers are required to display limit orders that are better than that market center’s current best bid or offer.”³⁷ Another commenter stated that the proposal would foster increased quote competition and ultimately narrow spreads, promote greater depth and liquidity, and minimize investor transaction costs.³⁸

A few commenters believed that a limit order display rule, without more, could harm investors.³⁹ One of these commenters stated that the proposed rule would likely be detrimental to retail and institutional investors looking to take sizeable positions in thinly traded stocks, as

³² See Knight Letter at 3.

³³ See SIFMA Letter at 3.

³⁴ See Knight Letter at 3; StockCross Letter at 2.

³⁵ Knight Letter at 3.

³⁶ See ArcaEdge Letter at 4; Knight Letter at 5; TD Ameritrade Letter at 2.

³⁷ TD Ameritrade Letter at 2.

³⁸ See ArcaEdge Letter at 4.

³⁹ See Mercator Letter at 1; STANY Letter at 2.

the displaying of a sizeable customer order will affect the way competing markets will react to the market.⁴⁰ One commenter noted that a limit order display rule could weaken the pricing leverage of a customer, as the displaying of an order “may well scare away bids or offers, since in thinly traded markets, many bids and offers are at risk quotes by market makers which are risking their own capital.”⁴¹ Another commenter stated that this proposal infringed upon the “experience and judgment of markets participants” and the “nature of any free market enterprise.”⁴²

One commenter believed that the proposed rule would act as a disincentive for broker-dealers to display quotations in an inter-dealer quotation system, because broker-dealers are free to withdraw from publishing a quotation in an OTC Equity Security at any time.⁴³ This commenter thus asserted that proposed Rule 6460 should be amended to require a broker-dealer that receives a customer limit order in an OTC Equity Security to execute the order, display the order in an inter-dealer quotation system or alternative trading system that makes its quotes publicly available, or transmit the order to another broker-dealer who will display the order.⁴⁴

A few commenters suggested alternatives to the proposed limit order display rule.⁴⁵ One of these commenters suggested permitting a broker-dealer to post part of a limit order, because small orders are more likely to be executed than large orders.⁴⁶ The other commenter stated that, while market makers should be required to display only the price of an order, they should have

⁴⁰ See Mercator Letter at 1.

⁴¹ Monroe Securities Letter at 1.

⁴² StockCross Letter at 1.

⁴³ See Pink OTC 2 Letter at 3-4.

⁴⁴ See id. at 4. The commenter acknowledged that its suggested change, however, would necessitate modifications to Rule 15c2-11 under the Act. See id.

⁴⁵ See Pink OTC Letter at 11-12; STANY Letter at 2.

⁴⁶ See STANY Letter at 2.

discretion over display of the size of the order.⁴⁷ Specifically, this commenter believed that a broker should have discretion with at least 50% of the aggregate order size, and should not be required to display size that is more than ten times the tier size with respect to any order or aggregate of orders at that price level.⁴⁸

Some commenters took issue with the proposed exceptions.⁴⁹ One commenter noted that, at a minimum, the proposed definition of “block-size” should be clarified, given the lack of liquidity of OTC Equity Securities.⁵⁰ Two commenters indicated that the current minimum quote size is a better standard for the required display size,⁵¹ and one commenter suggested that limit orders of less than the minimum quotation size for OTC Equity Securities should not be required to be displayed.⁵²

One commenter also proposed that Rule 6460 be amended to require the display of customer limit orders in OTC debt securities.⁵³

⁴⁷ See Pink OTC Letter at 11.

⁴⁸ See id.

⁴⁹ See Knight Letter at 5-6; Pink OTC Letter at 12; SIFMA Letter at 4.

⁵⁰ See SIFMA Letter at 4.

⁵¹ See Knight Letter at 5-6; SIFMA Letter at 4.

⁵² See Pink OTC Letter at 12.

⁵³ See Pink OTC 2 Letter at 5.

Access Fees. Some commenters voiced their opposition to access fees in general.⁵⁴ One commenter stated that such fees are especially harmful to the OTC market, which is characterized by relatively infrequent trading and less natural liquidity.⁵⁵ That commenter also noted that market makers have operated successfully without charging access fees.⁵⁶

Other commenters opposed the aspect of the proposal that would result in undisplayed access fees.⁵⁷ One commenter stated that FINRA should be required to demonstrate that the benefits of introducing “hidden” access fees exceed the “recognized harm hidden access fees cause to investor confidence and market quality.”⁵⁸ Other commenters stated that the current rule offers greater transparency,⁵⁹ and that the proposal is “in effect a license for all market participants to charge access fees and keep those fees hidden from the public quote.”⁶⁰ Another commenter noted that access fees in OTC equity markets constitute a significant component of the price of a security, and that removing the requirement to display access fees would “distort considerably the true market value of the security.”⁶¹ One commenter stated that this proposal would force market participants to pass fees on to the customer or pay the fees themselves when interacting with a displayed quotation.⁶² Yet another commenter stated that the proposal would

⁵⁴ See Mercator Letter at 2; STANY Letter at 2.

⁵⁵ See Mercator Letter at 2.

⁵⁶ See id.

⁵⁷ See Knight Letter at 4; Pink OTC Letter at 4.

⁵⁸ Pink OTC Letter at 5.

⁵⁹ See SIFMA Letter at 3.

⁶⁰ STANY Letter at 2.

⁶¹ Knight Letter at 4.

⁶² See StockCross Letter at 2.

result in an unlevel playing field in the OTCBB market, if only electronic communications networks or alternative trading systems could utilize undisplayed access fees.⁶³

Some commenters stated that the proposal would result in fee-driven gaming or the increased incidence of locked and crossed markets.⁶⁴ One such commenter noted that access fees in OTC equity markets constitute a “significant component” of the transaction and market price for a security, and that allowing the non-display of access fees would create “a new natural hunting ground for rebate trading” and large volumes that otherwise would not occur.⁶⁵ Market participants would take advantage of “inter-venue access fee quote arbitrage,” with the result being fee disputes and locked markets.⁶⁶ Another commenter stated that market participants have little incentive to lock or cross markets where non-displayed access fees are not permitted, and that markets without non-displayed access fees have lower compliance costs.⁶⁷ Another commenter stated that eliminating the requirement to display non-subscriber access fees would also reduce displayed liquidity and encourage “undisplayed sub-penny price jumping.”⁶⁸

Two commenters supported the proposed access fee cap.⁶⁹ One commenter stated that, by imposing a uniform limitation of fees, this proposal would contribute to an “accurate evaluation of the actual quotations displayed in the public markets.”⁷⁰ The other commenter stated that this requirement would foster a competitive market by “leveling the playing field

⁶³ See SIFMA Letter at 3.

⁶⁴ See Knight Letter at 4; Pink OTC Letter; at 5; STANY Letter at 2.

⁶⁵ Knight Letter at 4-5.

⁶⁶ Id. at 5.

⁶⁷ See Pink OTC Letter at 5.

⁶⁸ SIFMA Letter at 3.

⁶⁹ See ArcaEdge Letter at 3; TD Ameritrade Letter at 2.

⁷⁰ TD Ameritrade Letter at 2.

amongst all market participants,” as the current rule has “artificially supported a dealer-driven market.”⁷¹ That commenter also noted that uniform access fees would prevent access fee gaming.⁷²

Two commenters stated that the proposed fee cap should be revised to 30% of the minimum quoting increment,⁷³ as access fees greater than the quote increment are not, by definition, de minimis.⁷⁴ One commenter also stated that FINRA should consider rules requiring broker-dealers to charge equal access or post transaction fees to all non-subscribers.⁷⁵

IV. Amendment No. 1

In response to comments, FINRA filed Amendment No. 1 that proposed two substantive changes to its initial filing. First, FINRA proposed to amend Rule 6434 (Minimum Pricing Increment for OTC Equity Securities) to change the minimum quoting increment for orders and indications of interest priced under \$1.00 per share. Initially, FINRA proposed to permit increments as small as \$0.0001 for orders and indications of interest that were priced below \$1.00 and equal to or greater than \$0.01 per share, and quoting increments of \$0.000001 for orders and indications of interest priced below \$0.01 per share. As amended, FINRA proposed to permit quoting increments of \$0.0001 for orders and indications of interest priced under \$1.00 and equal to or greater than \$0.0001 per share. FINRA also proposed a limited exception for orders and indications of interest priced less than \$0.0001 per share. Under this exception, members would be permitted to rank or accept (but not display) orders and indications of interest in an increment of

⁷¹ ArcaEdge Letter at 3.

⁷² See id. at 4.

⁷³ See ArcaEdge Letter at 4; Pink OTC Letter at 10.

⁷⁴ See Pink OTC Letter 9.

⁷⁵ See ArcaEdge Letter at 4.

\$0.000001 or greater for orders and indications of interest that are priced under \$0.0001 per share. FINRA stated that this exception recognized the fact that some OTC Equity Securities trade at prices less than \$0.0001, and that restricting quoting in those securities to increments of \$0.0001 would effectively eliminate trading in those securities.⁷⁶ FINRA also noted that most systems could not display pricing increments smaller than four decimal places, and that requiring securities priced under \$1.00 and equal to or greater than \$0.0001 per share to be quoted in increments of \$0.0001 would promote uniformity in the OTC equity market at this price level.⁷⁷

Second, FINRA proposed to amend Rule 6450 (Restrictions on Access Fees) to revise the access fee cap on quotations priced below \$1.00 per share. As revised, the cap would be the lesser of 0.3% of the per-share quotation price, or 30% of the minimum permissible quotation increment. FINRA stated that this revised method of calculating access fees for securities priced under \$1.00 would “ensure that the access fee is always less than the relevant quotation increment.”⁷⁸

Finally, FINRA proposed to amend Rule 6460 (Display of Customer Limit Orders) to add an exception to the display requirement for customer limit orders priced less than \$0.0001 per share, to correspond with the revision to proposed Rule 6434 permitting members to rank or accept, but not display, orders and indications of interest priced below \$0.0001 per share in an increment as small as \$0.000001.

V. Summary of Comments on Amendment No. 1

Two comments were submitted in response to the Amended Notice. One commenter reiterated its opposition to the application of the proposed limit order display rule, and requested that the definition of “block size” for OTC securities be defined as an order that is “of at least

⁷⁶ See Amended Notice, 75 FR at 12586.

⁷⁷ See id.

⁷⁸ Id. at 12585.

10,000 shares or . . . has a market value of at least \$100,000.”⁷⁹ This commenter stated that the current rule is designed for penny stocks only, and that the proposed definition would give larger orders in non-penny stocks the benefit of the block-size exemption.⁸⁰

The second commenter reiterated its concerns with both the proposed limit order display requirement and the proposed rule against locked and crossed markets.⁸¹ This commenter noted that the proposed limit order display rule would not require the publication of a customer limit order if the broker-dealer handling the order were not a market maker, as defined under FINRA’s rules.⁸² In addition, the commenter stated that the proposed rule would not apply to market makers that do not publish a quotation in an inter-dealer quotation system for the security that is the subject of the customer limit order.⁸³ The commenter stated that the rule would discourage broker-dealers from making publicly displayed markets in OTC Equity Securities.⁸⁴

The commenter also criticized FINRA’s amended proposal regarding locked and crossed markets.⁸⁵ According to the commenter, FINRA stated in its amended proposal that it would be unreasonable to require broker-dealers to avoid locked and crossed markets across inter-dealer quotation systems because there is not a mandated quotation mechanism for OTC Equity Securities.⁸⁶ The commenter pointed out that it itself “currently disseminates a widely accessible, consolidated national best bid and offer for OTC Equity Securities” quoted in inter-dealer quotation

⁷⁹ Monroe 2 Letter at 1.

⁸⁰ See id.

⁸¹ See Pink OTC 3 Letter at 1.

⁸² See id. at 3.

⁸³ See id. at 2.

⁸⁴ See id. at 3.

⁸⁵ See id. at 4.

⁸⁶ See Pink OTC 3 Letter at 4.

systems.⁸⁷ The commenter stated that these data should be used by broker-dealers in avoiding locking and crossing markets across multiple inter-dealer quotation systems, and that FINRA should have purchased this market data from the commenter.

Finally, the commenter stated that, unlike in the market for NMS securities, no business model in the market for OTC Equity Securities depends on the receipt of access fees among broker-dealers.⁸⁸ As an alternative to the proposed rule, the commenter suggested that FINRA allow ECNs to trade on a riskless principal basis with non-subscriber broker-dealers.⁸⁹

VI. FINRA's Response to Comments on Amendment No. 1

In response to comments on the proposed limit order display rule, FINRA reiterated its view that the appropriate trigger for an obligation to display a customer limit order is when an OTC market maker already is displaying a priced quotation for the security in an inter-dealer quotation system (unless an exception applies).⁹⁰ FINRA similarly reiterated its view that, once triggered, the limit order display requirement should apply to the full size of a customer limit order.⁹¹ FINRA noted that its approach was consistent with the Commission's determination when it first proposed a limit order display rule that the presumption should be to display "unless such orders are of block size, the customer requests that its order not be displayed, or one of the exceptions to the rule applies."⁹²

⁸⁷ Id. at 5.

⁸⁸ See id. at 8.

⁸⁹ See id.

⁹⁰ See letter to Elizabeth M. Murphy, Secretary, Commission, dated June 22, 2010 from Racquel L. Russell, Assistant General Counsel, Regulatory Policy and Oversight ("FINRA Response Letter").

⁹¹ See id.

⁹² See id. at 3 (citing Securities Exchange Act Release No. 36310 (September 29, 1995) 60 FR 52792 (October 10, 1995)).

FINRA also responded to the issue of whether the prohibition on locked and crossed markets should apply across inter-dealer quotation systems. FINRA stated that, at this time, the prohibition on locked and crossed markets should apply only within (and thus not across) inter-dealer quotation systems “due to the lack of an SRO-sponsored widely accessible, consolidated national best bid and offer for OTC equity securities.”⁹³

FINRA also reiterated its position that the proposed cap on access fees is the fairest and most appropriate resolution of the access fee issue, and that proposed Rule 6450 “permits a landscape where market forces can drive the adoption of various business models in the OTC market.”⁹⁴

VII. Discussion and Findings

After careful consideration of the amended proposal, the comments received, and FINRA’s responses thereto, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.⁹⁵ In particular, the Commission finds that the proposal is consistent with Section 15A(b)(6) of the Act,⁹⁶ which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices; 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; to remove impediments to and perfect the mechanism of a free and open market and a national market

⁹³ Id. at 3-4.

⁹⁴ Id. at 4.

⁹⁵ In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁹⁶ 15 U.S.C. 78q-3(b)(6).

system; and, in general, to protect investors and the public interest. The Commission does not believe that any comments have been raised that should preclude approval of the proposal.

With this proposal, FINRA seeks to introduce into the market for OTC Equity Securities – over which it has supervisory responsibilities⁹⁷ – certain regulatory protections that were introduced by the Commission into the market for exchange-listed securities by Regulation NMS. The Commission adopted Regulation NMS in 2005 to “modernize and strengthen the national market system for equity securities.”⁹⁸ Among the elements of Regulation NMS were: (1) a rule establishing a uniform quoting increment of no less than one penny for quotations in NMS stocks equal to or greater than \$1.00 per share, to promote greater price transparency and consistency; (2) a cap on fees for accessing protected quotations, to ensure the “fairness and accuracy of displayed quotations by establishing an outer limit on the cost of accessing such quotations;”⁹⁹ and (3) a rule requiring the exchanges and FINRA to require their members reasonably to avoid locking or crossing protected quotations. Under the same authority used to establish Regulation NMS, the Commission had previously established a rule that generally requires display of customer limit orders.¹⁰⁰ Many of the same concerns expressed by the Commission in adopting Regulation NMS and the Limit Order Display Rule for exchange-listed securities also apply to the market in OTC Equity Securities. The rules proposed here by FINRA appear reasonably designed to address these

⁹⁷ See Section 15A(b)(11) of the Act, 15 U.S.C. 78o-3(b)(11) (rules of a national securities association must “include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange”).

⁹⁸ Securities Exchange Act Release 51808 70 FR 37496, 37496 (June 29, 2005) (“Reg NMS Adopting Release”).

⁹⁹ Reg NMS Adopting Release, *id.*, 70 FR at 37502.

¹⁰⁰ See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (adopting Rule 11Ac1-4 under the Act, which requires the display of customer limit orders priced better than a specialist’s or OTC market maker’s quote) (“Limit Order Display Release”).

concerns, and follow closely the regulatory approach set forth in the Commission's rules. Therefore, the Commission believes that FINRA's proposal is consistent with the Act.

With respect to the proposal to restrict sub-penny quoting, the Commission agrees with FINRA that the same concerns that were articulated in the context of Regulation NMS also exist for OTC Equity Securities. Such concerns include "stepping ahead" of standing limit orders by an economically insignificant amount, which reduces incentives to display limit orders and provide liquidity to the markets, and the increased incidence of "flickering quotes" and the resulting regulatory compliance and capacity burdens.¹⁰¹

Like Rule 612 of Regulation NMS,¹⁰² proposed FINRA Rule 6434 requires that the minimum increment for bids, offers, orders, and indications of interest priced \$1.00 or more per share is one penny. Furthermore, like Rule 612, proposed FINRA Rule 6434 requires that the minimum increment for bids, offers, orders, and indications of interest priced between \$1.00 and \$0.0001 per share is one hundredth of a penny. Unlike Rule 612, however, proposed FINRA Rule 6434 contains an additional provision for bids, offers, orders, and indications of interest priced below \$0.0001 per share. Under this provision, a member may rank or accept (but not display) an order or indication of interest in an increment as small as \$0.000001.¹⁰³ FINRA stated that this exception recognizes the fact that some OTC Equity Securities trade at prices less than \$0.0001, and that restricting quoting in those securities to increments of \$0.0001 would effectively eliminate trading in those securities.¹⁰⁴

¹⁰¹ See Reg NMS Adopting Release, supra note 98, 70 FR at 37553.

¹⁰² 17 CFR 242.612.

¹⁰³ In the FINRA Response Letter, FINRA noted that a member's customer order protection obligations under IM-2110-2 (Trading Ahead of Customer Limit Order) continue to apply. See FINRA Response Letter, supra note 90 at 2.

¹⁰⁴ See Amended Notice, 75 FR at 12586.

The Commission believes that proposed Rule 6434 is consistent with the Act because it adopts pricing increments similar to those set forth in Rule 612. Although the proposed rule differs from Rule 612 in that it permits acceptance of orders and indications of interest priced below \$0.0001 per share in finer increments, the Commission believes that this is a reasonable accommodation given that certain OTC Equity Securities currently trade at very low prices.

With respect to FINRA's proposal regarding locking or crossing quotations, the Commission agrees with FINRA that many of the same concerns that were articulated in the context of Regulation NMS – namely, that locked and crossed markets may confuse investors and create market inefficiencies¹⁰⁵ – also exist for OTC Equity Securities. In response to commenters inquiring why FINRA did not extend this rule across inter-dealer quotation systems, FINRA stated that it is not practicable to extend locking and crossing restrictions across inter-dealer markets due to the lack of a widely accessible, consolidated national best bid and offer for OTC Equity Securities. The Commission believes that FINRA's proposal is consistent with the Act and is a reasonable first step to address problems caused by locked and crossed markets, while recognizing the market data limitations for OTC Equity Securities.

The Commission also finds that FINRA's proposal regarding access fees is consistent with the Act, for the same reasons that the Commission adopted its own rules regarding access fees. In the Reg NMS Adopting Release, the Commission noted that a flat access fee was the “fairest and most appropriate solution to what has been a longstanding and contentious issue.”¹⁰⁶ The Commission noted that this fee would apply equally to ECNs, market makers, and other trading centers.¹⁰⁷ The Commission also noted that, for quotations to be fair and useful, “there must be

¹⁰⁵ See Reg NMS Adopting Release, supra note 98, 70 FR at 37547.

¹⁰⁶ Reg NMS Adopting Release, supra note 98, 70 FR at 37545.

¹⁰⁷ See id.

some limit on the extent to which the true price can vary from the displayed price,” and concluded that the cap on access fees “harmoniz[ed] quotation practices and preclude[ed] the distortive effects of exorbitant fees.”¹⁰⁸ The Commission agrees with FINRA that the same considerations apply here. In capping the fees that may be charged to access a quotation in an OTC Equity Security, and in drafting the rule to apply to ATSS, ECNs, and market makers, the proposed rule is reasonably designed to promote transparency and fair competition in the market for OTC Equity Securities.

As noted above, a number of commenters argued that this access fee provision applicable to sub-penny quotations, as originally proposed, could lead to certain gaming activity. In response to these comments, FINRA proposed in Amendment No. 1 to modify the cap on access fees for sub-penny quotations. Specifically, the access fee cap would be the lesser of 0.3% of the published quotation price on a per-share basis, or 30% of the minimum allowable increment. The Commission believes that the amended proposal is reasonably designed to minimize access fee gaming, as it prevents the access fee from exceeding the minimum quoting increment.

Finally, the Commission finds that FINRA’s proposal to adopt a limit order display rule is consistent with the Act. With certain exceptions, the proposal requires a market maker displaying a priced quote in an inter-dealer quotation system to immediately display a customer limit order that it receives that (1) improves the price of the bid or offer displayed by the market maker, or (2) improves the size of its bid or offer by more than a de minimis amount where it is priced equal to the best bid or offer in the inter-dealer quotation system where the market maker is quoting. The Commission believes that extending limit order display requirements to OTC Equity Securities is reasonably designed to increase transparency in the market for OTC Equity Securities. As it has

¹⁰⁸

Id.

previously stated, the Commission believes that limit orders are a valuable component of price discovery, and that uniformly requiring display of such orders will encourage tighter, deeper, and more efficient markets.¹⁰⁹ Commenters generally supported the proposed limit order display requirement, although some commenters requested certain clarifications and modifications. In response to comments, FINRA noted in Amendment No. 1 that its proposed limit order display rule would not require display of customer orders that would result in a violation of the minimum quotation size tiers prescribed in FINRA Rule 6450 (Minimum Quotation Size Requirements For OTC Equity Securities).¹¹⁰ FINRA also proposed a new exception for limit orders priced less than \$0.0001 per share, consistent with the changes made to proposed FINRA Rule 6434 prohibiting the display of a bid or offer, order, or indication of interest in any OTC Equity Security priced less than \$0.0001 per share.¹¹¹

One commenter expressed concern that the proposed limit order display rule would apply only to OTC market-makers, rather than to all broker-dealers displaying a priced quotation in an inter-dealer quotation system or ECN, which could lead to a reduction in quotation activity in OTC Equity Securities. The Commission notes that FINRA's limit order display proposal acknowledges the role that market makers traditionally have played in providing price discovery and liquidity to the OTC Equity Securities market.

Further, in response to commenters' concerns that market makers be permitted greater discretion to display only a portion of a customer limit order, FINRA noted that, where the

¹⁰⁹ See Limit Order Display Release, supra note 100, 61 FR at 48294. Rule 11Ac1-4, which was adopted prior to the approval of The Nasdaq Stock Market as a national securities exchange, applied generally to exchange specialists and Nasdaq market makers. Rule 11Ac1-4 was subsequently redesignated as Rule 604 under Regulation NMS. See NMS Adopting Release, supra note 98.

¹¹⁰ See Amended Notice, supra note 7.

¹¹¹ See id.

member believes that a customer would be best served by not displaying the full size of a limit order, the member is free to obtain the customer's consent to refrain from displaying such customer's order, as permitted by a proposed exception to the limit order display requirement. As it has previously stated, the Commission believes that the presumption of limit order display is the proper approach.¹¹² The Commission further believes that FINRA's limit order display proposal marks a positive step in efforts to improve the transparency of OTC Equity Securities and the handling of customer limit orders in this market sector.

¹¹² See Limit Order Display Release, *supra* note 100, 61 FR at 48301 (stating “[t]he Commission believes that the rule appropriately establishes a presumption that limit orders should be displayed, unless such orders are of block size, the customer requests that its order not be displayed, or one of the exceptions to the rule applies. The exception allowing a customer to request that its limit order not be displayed gives the customer ultimate control in determining whether to trust the display of the limit order to the discretion of a market professional, or to display the order either in full, or in part, to other potential market interest.”).

VIII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-FINRA-2009-054), as modified by Amendment No. 1 thereto, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹¹³

Florence E. Harmon
Deputy Secretary

¹¹³ 17 CFR 200.30-3(a)(12).