

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63032; File No. SR-FINRA-2010-043)

October 4, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to Reinstitute Short Exempt Marking for Trade Reporting and OATS

I. Introduction

On August 6, 2010, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “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 amend FINRA’s trade reporting and Order Audit Trail System (“OATS”) rules, including changes relating to recent amendments to SEC Regulation SHO. The proposed rule change was published for comment in the Federal Register on August 26, 2010.³ The Commission received two comment letters on the proposal,⁴ and a letter from FINRA responding to the comments.⁵ This order approves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 62748 (Aug. 20, 2010), 75 FR 52574 (Aug. 26, 2010).

⁴ See Letter from Mike Wiesenber, dated September 8, 2010 (“Wiesenber Letter”); Letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth M. Murphy, Secretary, Commission, dated September 17, 2010 (“FIF Letter”).

⁵ See Letter from Brant K. Brown, Associate General Counsel, FINRA to Elizabeth M. Murphy, Secretary, Commission, dated September 28, 2010 (“FINRA Response Letter”).

II. Description of the Proposed Rule Change

On February 26, 2010, the SEC adopted amendments to SEC Regulation SHO.⁶ These amendments, among other things, implement a short sale circuit breaker for NMS stocks⁷ triggered by a 10% or more decrease in the price of the security from such security's closing price as determined by the listing market for that security at the end of regular trading hours on the prior trading day. Once the circuit breaker is triggered, Regulation SHO, as amended, is designed to generally prohibit the execution or display of short sale orders of a covered security at a price that is less than or equal to the current national best bid for the remainder of the day and the following day ("short sale price test restriction"). In addition to the short sale price test restriction, the amendments to Regulation SHO reinstate a short sale exempt marking category by providing that a broker-dealer may mark certain qualifying sell orders "short exempt."⁸

Paragraphs (c) and (d) of Rule 201 of SEC Regulation SHO set forth the provisions pursuant to which an order may be marked "short exempt" once the circuit breaker has been triggered pursuant to paragraph (b)(3). These provisions include:

- Broker-dealer policies and procedures provision;

⁶ See Securities Exchange Act Release No. 61595 (February 26, 2010), 75 FR 11232 (March 10, 2010).

⁷ NMS stock means any NMS security other than an option. Rule 600(b)(46) of SEC Regulation NMS defines "NMS security" as any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. See 17 CFR 242.600(b)(46).

⁸ The Commission amended Rule 200(g) of Regulation SHO to add a "short exempt" marking requirement. The amendments to SEC Regulation SHO became effective on May 10, 2010 with a compliance date of November 10, 2010. See supra note 6.

- Seller’s delay in delivery;
- Odd lot transactions;
- Domestic arbitrage;
- International arbitrage;
- Over-allotments and lay-off sales;
- Riskless principal transactions; and
- Transactions on a volume-weighted average price basis (or “VWAP”).⁹

In light of the reinstatement of the “short exempt” marking category, FINRA has proposed to amend its trade reporting rules applicable to over-the-counter trades in NMS stocks to reintroduce the short sale exempt category.¹⁰ Specifically, FINRA has proposed that, for short sales in all NMS stocks as defined in Rule 600(b)(47) of SEC Regulation NMS, members must indicate on trade reports submitted to FINRA if a transaction is “short sale exempt” (i.e., if it is a short sale transaction in a “covered security” that may be marked “short exempt” pursuant to SEC Regulation SHO).¹¹

⁹ SEC staff has confirmed that members may use the existing “.W” modifier in connection with the VWAP exception of Rule 201(d)(7) of Regulation SHO. The use of the .W modifier would be in addition to the requirement to report the trade as short exempt.

¹⁰ See FINRA Rules 6182 (Trade Reporting of Short Sales), 6282 (Alternative Display Facility), 6380A (FINRA/Nasdaq TRF), 6380B (FINRA/NYSE TRF), 7230A (FINRA/Nasdaq TRF), and 7230B (FINRA/NYSE TRF).

¹¹ FINRA previously required trade reports to indicate if a transaction was marked “short exempt”; however, these requirements were eliminated following the repeal of SEC Rule 10a-1. See Securities Exchange Act Release No. 56279 (August 17, 2007), 72 FR 48713 (August 24, 2007) (Notice of Filing and Immediate Effectiveness of File No. SR-NASD-2007-047).

Similarly, FINRA has proposed to amend its OATS rules to provide that, when an order is received or originated, members must record the designation of an order as a short sale exempt order if the order may be marked “short exempt” pursuant to SEC Regulation SHO.¹² FINRA also has proposed to require that members include the price on all route reports and a short exempt identifier, if applicable.¹³

FINRA has proposed certain additional amendments to its trade reporting rules, including those applicable to OTC Equity Securities, as defined in Rule 6420 (i.e., non-NMS stocks) to clarify certain existing reporting requirements.¹⁴ First, FINRA has proposed to clarify that the short sale indicator (and short sale exempt indicator, for NMS stocks) is required on reports of a “cross,” as well as reports of a “sell.”

Second, FINRA has proposed to codify the existing requirement that the information listed in the rule must be provided for each trade that is reported to FINRA. Today, trade report information can be provided in a single report, if the reporting member submits trade information for both sides of the trade, or it can be provided in a combination of reports, if the reporting member and contra side each submit their own trade information (as described more fully below), which will be codified in the rule upon

¹² See FINRA Rule 7440(b)(9).

¹³ Whenever a member transmits an order to another member, ECN, non-member or national securities exchange for handling or execution, the routing member is responsible for recording and reporting a route report to OATS. Under the proposal, route reports would be required to include the price at which the order was routed, which may be different from the price received from the customer, and whether the routed order is short exempt. The short exempt identifier is important for purposes of route reports because certain short sale orders will be eligible to be marked exempt solely as a result of the timing and price of the routed order (See Rule 201(c) of SEC Regulation SHO).

¹⁴ See FINRA Rules 6282, 6380A, 6380B, 6622, 7230A, 7230B and 7330.

implementation of the proposed changes. For each trade reported to FINRA, members must indicate, among other things, whether the seller (either the reporting member or contra side, irrespective of whether the contra side is a member) is selling short or, upon implementation of the proposed changes, short exempt.

Unless the contra side will have an opportunity to provide its own trade information (i.e., unless the contra side is a member using the trade comparison functionality of the facility),¹⁵ the reporting member is responsible for providing complete and accurate information for both sides of the trade, including information from the contra side perspective such as sell short and, upon implementation of the proposed changes, sell short exempt, as applicable. Thus, the reporting member is responsible for satisfying any applicable contra side information requirements where: (1) the trade is with a customer or non-member, (2) the trade is with a member and is “locked in” pursuant to a give up agreement, or (3) the trade is reported as “tape only” (i.e., for public dissemination purposes without clearing) or “non-tape, non-clearing.” This reporting requirement is in effect today; however, the proposed rule change would make it an express requirement in the rule. If the contra side is a member and will have an opportunity to provide its own trade information, then the reporting member is

¹⁵ The trade comparison functionality allows the contra party to accept or decline the trade information submitted by the reporting party and may only be used by a contra party that is a member. FINRA notes that the Alternative Display Facility, FINRA/Nasdaq TRF and ORF offer trade comparison functionality; the FINRA/NYSE TRF does not offer such functionality. Accordingly, reporting members are responsible for accurately and completely providing all information required under the rule for the contra side when reporting to the FINRA/NYSE TRF.

responsible only for providing information from the reporting side perspective (and the contra side will provide information from the contra side perspective).

FINRA has stated that the implementation date will be November 10, 2010.

III. Comment Letters

The Commission received two comment letters in response to the proposed rule change.¹⁶ The Commission also received FINRA's response to comments.¹⁷ The comment letters, as well as FINRA's response, are discussed below.

The FIF Letter raises a number of concerns regarding the proposal. Specifically, the FIF Letter raises concerns regarding the November 10, 2010 implementation date for the proposed rule changes given other regulatory initiatives with similar implementation timeframes. In response to these concerns, FINRA points out that the proposed amendments are to facilitate its surveillance efforts concerning firms' compliance with amendments to Regulation SHO, which becomes effective November 10, 2010. FINRA believes that it is necessary that the implementation date of the proposed amendments coincide with the implementation date of the amendments to Regulation SHO.

The FIF Letter also raises concerns with the amount of time allowed for testing prior to implementation of the proposed amendments. In response, FINRA has represented that it has moved up the testing timetable to allow firms to begin testing on October 11th, rather than on October 20th as initially proposed.

The FIF Letter expresses concerns regarding the complexity of the proposed changes and cites the creation of certain route reports for post trade agency allocation as an example of such complexity. FINRA explains that the requirement to provide the

¹⁶ See Wiesenberg Letter and FIF Letter.

¹⁷ See FINRA Response Letter. See also supra note 5.

price of a routed order on route reports does not change any of the reporting requirements for orders handled on an agency average price or post trade allocation basis. FINRA also states that it has published a new FAQ on its OATS web site on this issue.

Lastly, the FIF Letter indicates that there may be confusion regarding the proposed November 10th implementation date of the proposed rule change and the November 8th date when the changes will be available in the OATS production environment.¹⁸ FINRA clarifies that although the OATS field format changes will be placed in the production environment on November 8th, they will not be required to be populated until the proposed November 10th implementation date of the proposed rule change. FINRA also states that it has published a new FAQ on its OATS web site to this effect.

The Wiesenberg Letter raises an issue, not with respect to one of the proposed amendments in the proposed rule change, rather with respect to one of the proposed requirements in FINRA's OATS Reporting Technical Specifications¹⁹ related to the proposed rule change, the addition of the Routed Order Type Indicator. The commenter believes that the proposed requirement "can be determined from [other OATS] information supplied" by the reporting member, "serve[s] no purpose" and "provides no

¹⁸ The FIF Letter also raises concerns regarding the ISO Indicator on route reports. FINRA notes that firms are already required to indicate on route reports whether an order is routed as an Intermarket Sweep Order. FINRA also points out that the ISO indicator is not one of the proposed amendments in the proposed rule change and therefore should not affect the Commission's consideration of the proposal.

¹⁹ FINRA's OATS Reporting Technical Specifications outline detailed reporting requirements concerning the OATS rules, including, among other things, providing firms with record and file formats and transmission requirements.

useful additional information.”²⁰ The commenter also generally questions whether such requirement is consistent with the Act and urges FINRA to reconsider the proposed requirement in FINRA’s OATS Reporting Technical Specifications and re-file the proposed rule change²¹ or, in the alternative, that the Commission reject the proposal. FINRA disagrees with the commenter and responds that the Routed Order Type Indicator “helps FINRA to validate whether a price must be included on a Route Report, particularly since the order type of a route may not be the same as the order type of the parent order received from the firm.”²²

IV. Discussion and Commission’s Findings

After careful review of the proposed rule change, the comment letters received and the FINRA Response Letter, the Commission believes that the proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to a national securities association.²³ In particular, the Commission believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

²⁰ See Wiesenberg Letter.

²¹ The commenter’s suggestion that FINRA re-file the proposed rule change would not address the addition of the Routed Order Type Indicator, as such requirement is contained in FINRA’s OATS Reporting Technical Specifications, not the proposed rule change.

²² See FINRA Response Letter.

²³ In approving the 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).

With regard to the comments received, the Commission believes that FINRA has adequately responded to the commenters' concerns. Additionally, the Commission agrees with FINRA and believes that the proposed rule change to amend FINRA's trade reporting and OATS rules, including changes relating to recent amendments to SEC Regulation SHO, will enhance FINRA's surveillance for member compliance, including with SEC Regulation SHO.

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (File No. SR-FINRA-2010-043) be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Florence E. Harmon
Deputy Secretary

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).