

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-65695; File No. SR-FINRA-2011-051)

November 4, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Allow FINRA to Grant Exemptions from Certain Equity Trade Reporting Obligations for Certain Alternative Trading Systems

I. Introduction

On September 16, 2011, 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 adopt new rules that will allow FINRA to grant exemptions from certain equity trade reporting obligations for alternative trading systems (“ATs”) meeting specified criteria. The proposed rule change was published for comment in the Federal Register on September 29, 2011.³ The Commission received three comment letters on the proposed rule change.⁴ FINRA responded to the comments in a letter dated November 4, 2011.⁵ This order approves the proposed rule change.

II. Description of the Proposal

Proposed FINRA Rules 6183 and 6625 will provide FINRA with new authority to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 65388 (September 23, 2011), 76 FR 60567 (July 26, 2011) (“Notice”).

⁴ See letter from Suzanne H. Shatto, dated October 20, 2011 (“Shatto Letter”); letter from Naphtali M. Hamlet, Investor, dated October 21, 2011 (“Hamlet Letter”); letter from Daniel Zinn, General Counsel, OTC Markets Group Inc., dated October 20, 2011 (“OTC Markets Letter”).

⁵ See letter from Lisa C. Horrigan, Associate General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated November 4, 2011 (“FINRA Response”).

exempt a member ATS that meets the specified criteria from the trade reporting obligation under the equity trade reporting rules. In addition, FINRA will adopt a conforming change to Rule 9610 to specify that FINRA has exemptive authority under the new rules.

As described in the Notice, existing FINRA rules require the reporting of over-the-counter (“OTC”) transactions in equity securities⁶ by the “executing party.” The term “executing party” is defined as the FINRA member that receives an order for handling or execution or is presented an order against its quote, does not subsequently re-route the order, and executes the transaction. For a trade executed on an ATS, the ATS is the “executing party” and thus has the trade reporting obligation.⁷

Under FINRA’s new rules, for an ATS to qualify for an exemption, the following conditions must be satisfied:

First, trades must be between ATS subscribers that are both FINRA members. For any trades between non-members or a FINRA member and a non-member, the exemption will not apply, and the ATS will have the trade reporting obligation under FINRA rules.

In addition, the ATS must demonstrate that the following criteria are met: (1) the

⁶ Specifically, these transactions are: (1) transactions in NMS stocks, as defined in SEC Rule 600(b) of Regulation NMS, effected otherwise than on an exchange, which are reported through the Alternative Display Facility or a Trade Reporting Facility; and (2) transactions in OTC Equity Securities and Restricted Equity Securities, as those terms are defined in Rule 6420, which are reported through the OTC Reporting Facility. As noted in the proposal, the new rules will apply to OTC transactions in equity securities only. The rules will not apply to TRACE-eligible securities. TRACE-eligible securities are subject to a separate reporting structure under FINRA’s Rule 6700 Series.

⁷ See Securities Exchange Act Release No. 58903 (November 5, 2008), 73 FR 67905 (November 17, 2008) (Order Approving File No. SR-FINRA-2008-011); and Regulatory Notice 09-08 (January 2009). See also, e.g., Trade Reporting Frequently Asked Questions, Sections 307 and 308, available at www.finra.org/Industry/Regulation/Guidance/P038942. As described in the proposal, the term ATS includes electronic communications networks.

member subscribers must be fully disclosed to one another at all times on the ATS; (2) although the system brings together the orders of buyers and sellers and uses established, non-discretionary methods under which such orders interact with each other, the system does not permit automatic execution. A member subscriber must take affirmative steps beyond the submission of an order to agree to a trade with another member subscriber; (3) the trade does not pass through any ATS account, and the ATS does not in any way hold itself out to be a party to the trade; and (4) the ATS does not exchange shares or funds on behalf of the member subscribers, take either side of the trade for clearing or settlement purposes, including, but not limited to, at DTC or otherwise, or in any other way insert itself into the trade.

The ATS and its FINRA member subscribers must also acknowledge and agree in writing that the ATS shall not be deemed a party to the trade for purposes of trade reporting and that trades shall be reported by the subscriber that, as between the two counterparties to the trade, would satisfy the definition of “executing party” under FINRA trade reporting rules. An ATS that is granted an exemption would have to obtain such written agreements from all of its FINRA member subscribers prior to relying on the exemption. Any ATS granted an exemption under the new rules would be required to retain the written agreements and be able to produce them to FINRA upon request.

Finally, the ATS must agree to provide to FINRA on a monthly basis, or such other basis as prescribed by FINRA, data relating to the volume of trades, by security, executed by the ATS’s member subscribers using the ATS’s system (e.g., number of trades, number of shares traded and total settlement value for each security traded). The ATS also must acknowledge that failure to report such data to FINRA, in addition to constituting a violation

of FINRA rules, would result in revocation of any exemption granted pursuant to the new rules.

Where FINRA grants an exemption pursuant to Rules 6183 or 6625, the ATS will not be deemed a party to the trade for purposes of FINRA trade reporting rules and will not be identified in trade reports submitted to FINRA. The ATS will bear no responsibility for reporting such transactions. The transaction, however, must be reported to FINRA by the member subscriber that, as between the two member subscribers who are the counterparties, satisfies the definition of “executing party” under paragraph (b) of Rules 6282, 6380A, 6380B, or 6622. In addition, where an ATS has been granted an exemption under the new rules, the member subscribers, as the parties identified in the trade report, will be assessed regulatory transaction fees under Section 3 of Schedule A to the FINRA By-Laws and the Trading Activity Fee under FINRA By-Laws, Schedule A, § 1(b)(2). The ATS would not be assessed such fees.

Notwithstanding an exemption, any transactions that occur through the ATS would be considered volume of the ATS for purposes of, among other things, various provisions of Regulation ATS. Such provisions include the recordkeeping requirements of Rule 302,⁸ the display requirements under Rule 301(b)(3),⁹ the access requirements under Rule 301(b)(5),¹⁰ and the capacity, integrity, and security requirements of Rule 301(b)(6).¹¹

The effect of an exemption provided pursuant to FINRA Rules 6183 and 6625 is illustrated in the following example that was included in the Notice: FINRA member BD1

⁸ 17 CFR 242.302.

⁹ 17 CFR 242.301(b)(3).

¹⁰ 17 CFR 242.301(b)(5).

¹¹ 17 CFR 242.301(b)(6).

displays a quote through ATS X and member BD2 routes an order to BD1 for the price and size of BD1's quote using a messaging system provided by ATS X. BD1 does not subsequently re-route the order and executes the trade. Assuming that ATS X meets all of the criteria set forth in the proposed rule and has been granted an exemption by FINRA, it will not be deemed a party to the trade for trade reporting purposes and should not be identified as such in the trade report submitted to FINRA. In this example, BD1 is the "executing party" and has the obligation to report the trade between BD1 and BD2.

FINRA stated that the proposed rule change will be effective on the date of Commission approval.

III. Summary of Comment Letters

Among the three comment letters received, two of the commenters expressed concern about dark pools and their potential impact on the fairness and transparency of the national market system.¹² One of these commenters suggested that dark pools be prohibited entirely.¹³ FINRA responded that these arguments are not germane to the proposal, which does not change the level of transparency that currently exists.¹⁴ FINRA stated that all trades executed on an ATS, including a dark pool, must be reported to FINRA and are publicly disseminated. With respect to any ATS that is granted an exemption under the proposed rule change, all of the trades executed on the ATS would continue to be reported for public dissemination.

Another commenter challenged the need for any new rules at all.¹⁵ This commenter

¹² See Shatto Letter; Hamlet Letter.

¹³ See Shatto Letter.

¹⁴ See FINRA Response at 3.

¹⁵ See OTC Markets Letter at 1-2.

asserted that any ATS that meets the criteria set out in the proposed rule change would not be an executing party, and consequently, would not be subject to any reporting obligation under current FINRA rules. On this basis, the commenter concluded that the proposal is unnecessary and should not be approved by the Commission, because no FINRA exemption is necessary for entities that bear no regulatory obligation.

FINRA responded that this commenter's assertion is based on an erroneous interpretation of FINRA rules and directly at odds with statements made by FINRA in the original filing.¹⁶ FINRA noted previous interpretations and guidance that an ATS is the "executing party" and has the trade reporting obligation where the transaction is executed on the ATS.¹⁷ FINRA reiterated its belief that an ATS that satisfies the criteria set forth in the proposal has a more limited involvement in the trade execution than the member subscribers, and therefore, the proposed exemption is appropriate in this narrow instance.

The commenter further stated that, notwithstanding its opposition, were the Commission inclined to approve FINRA's proposal, the proposed rules should be modified.¹⁸ First, the commenter asserted that the exemption authority should be expanded to cover TRACE-eligible securities, because there is no meaningful basis to distinguish the reporting rules and obligations associated with this class of securities from those for other securities.

FINRA responded that the comment goes beyond the scope of the instant proposal, but that it would consider the comment separately.¹⁹ FINRA stated that if it determines that a similar exemption is appropriate for TRACE reporting, FINRA would submit a separate rule

¹⁶ See FINRA Response at 1-2.

¹⁷ See note 7 supra.

¹⁸ See OTC Markets Letter at 2.

¹⁹ See FINRA Response at 2.

filing to effect that change.

In addition, the commenter argued that the criteria for the exemption should be clarified in certain respects.²⁰ FINRA disagreed with the comment and reasserted its belief that the criteria for the exemption were sufficiently clear.²¹

Finally, the commenter argued that the proposed exemption should be automatic, and not subject to FINRA staff discretion.²² The commenter maintained that FINRA has not explained the “relevant factors” that FINRA staff would consider, which could lead to inconsistent application of the new rules. FINRA responded that it is important for its staff to have the opportunity to review an ATS’s application for exemptive relief and to make a determination whether the ATS meets the criteria in the proposed rule before the ATS is able to rely on the exemption.²³ FINRA believes that it is important to know in advance which party – the ATS or one of its subscribers – will have the trade reporting obligation. FINRA stated that, while it expects to grant an exemption to any ATS that can demonstrate that it meets all of the criteria set forth in the new rules, FINRA staff should have notice and discretion in the event of a disagreement with an ATS about whether it qualifies for an exemption under the proposed rule. FINRA plans to post on its website which ATSs are operating under any exemption granted pursuant to the new rules.

IV. Discussion and Commission’s Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and FINRA’s response to the comments, and finds that the proposed rule change is

²⁰ See OTC Markets Letter at 3-6.

²¹ See FINRA Response at 2.

²² See OTC Markets Letter at 7.

²³ See FINRA Response at 2-3.

consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.²⁴ In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²⁵ 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, and, in general, to protect investors and the public interest.

As described above, the proposal is designed to provide FINRA the authority to exempt an ATS from reporting obligations under FINRA's equity trade reporting rules where the ATS does not perform all the functions normally associated with those of an executing party. Where an exemption is granted, the duty to report will fall on one of the subscribers that is a counterparty to the trade and that itself satisfies the definition of "executing party." The Commission believes that the exemption mechanism is reasonably designed to promote efficient reporting of OTC transactions in equity securities, and that FINRA can – consistent with the Exchange Act – be afforded some discretion regarding which of its members should have the duty to report a trade when there are multiple members who could potentially assume that duty.

The Commission does not believe that any commenters raised issues that would preclude approval of this proposal. The Commission believes that the proposal is sufficiently clear, and modifications are not necessary to allow the Commission to find it consistent with the Act. Furthermore, the comments that raised issues with dark pools go beyond the scope of the present proposal. All transactions currently subject to reporting will continue to be

²⁴ In approving this proposed rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²⁵ 15 U.S.C. 78o-3(b)(6).

reported; the new rules merely allow FINRA to reassign the duty to report in certain circumstances.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁶ that the proposed rule change (SR-FINRA-2011-051) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁷

Kevin M. O'Neill
Deputy Secretary

²⁶ 15 U.S.C. 78s(b)(2).

²⁷ 17 CFR 200.30-3(a)(12).