

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-66168; File No. SR-FINRA-2011-058)

January 17, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Change to Amend FINRA Rule 6433 (Minimum Quotation Size Requirements for OTC Equity Securities)

I. Introduction

On October 6, 2011, 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 amend FINRA Rule 6433 (“Rule”), which governs minimum quotation size requirements for OTC Equity Securities.³ The proposed rule change is designed to simplify the Rule’s price and size tiers; facilitate the display of customer limit orders under new FINRA Rule 6460 (Display of Customer Limit Orders) (“FINRA limit order display rule”);⁴ and expand the scope of the Rule. The proposed rule change was published for comment in the Federal Register on October 20, 2011.⁵ On November 17, 2011, FINRA consented to extending the time period for the Commission to either approve or disapprove the proposed rule change or to institute

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ “OTC Equity Security” means “any equity security that is not an NMS stock as that term is defined in Rule 600(b)(47) of SEC Regulation NMS; provided, however, that the term ‘OTC Equity Security’ shall not include any Restricted Equity Security.” See FINRA Rule 6420(e).

⁴ See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010) (Order Approving NMS-Principled Rules for OTC Equity Securities) (“NMS-Principled Rules Approval Order”). FINRA Rule 6460 became operative on May 9, 2011.

⁵ See Securities Exchange Act Release No. 65568 (October 14, 2011), 76 FR 65307 (“Notice”).

proceedings to determine whether to disapprove the proposed rule change, to January 18, 2012. The Commission received seven comment letters on the proposal from four separate commenters,⁶ as well as two responses to the comment letters from FINRA.⁷ This order institutes proceedings under Section 19(b)(2)(B) of the Act⁸ to determine whether to disapprove the proposed rule change.

II. Description of the Proposal

FINRA proposed changes to the minimum quotation sizes in FINRA Rule 6433, among other things, to simplify the Rule's price and size tiers; facilitate the display of customer limit orders under new FINRA Rule 6460;⁹ and expand the Rule's scope. In its filing, FINRA noted, among other things, that currently FINRA Rule 6433 requires every member functioning as an OTC Market Maker¹⁰ in an OTC Equity Security that enters firm quotations into any inter-dealer

⁶ See Letter from Suzanne H. Shatto, dated October 20, 2011 ("Shatto Letter"); Letter from Naphtali M. Hamlet, dated October 21, 2011 ("Hamlet Letter"); Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth M. Murphy, Secretary, Commission, dated November 10, 2011 ("OTC Markets Letter I"); Letter from Michael T. Corrao, Managing Director, Knight Capital Group, Inc. to Elizabeth M. Murphy, Secretary, Commission, dated November 16, 2011 ("Knight Letter I"); Letter from R. Cromwell Coulson, President & CEO, OTC Markets to Craig Lewis, Commission, and Kathleen Hanley, Commission, dated November 18, 2011 ("OTC Markets Letter II"); Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth M. Murphy, Secretary, Commission, dated December 30, 2011 ("OTC Markets Letter III"); Letter from Michael T. Corrao, Managing Director, Knight Capital Group, Inc. to Elizabeth M. Murphy, Secretary, Commission, dated January 13, 2012 ("Knight Letter II").

⁷ See Email from Marc Menchel, FINRA to John Ramsay, David S. Shillman, and Nancy J. Sanow, Commission, dated November 30, 2011 ("FINRA Response I"); and Letter from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA to Elizabeth M. Murphy, Secretary, Commission, dated December 23, 2011 ("FINRA Response II").

⁸ 15 U.S.C. 78s(b)(2)(B).

⁹ See NMS-Principled Rules Approval Order, supra note 4.

¹⁰ OTC Market Maker" means "a member of FINRA that holds itself out as a market maker by entering proprietary quotations or indications of interest for a particular OTC Equity

quotation system that permits quotation updates on a real-time basis to honor those quotations for certain minimum sizes (“minimum quotation sizes”).¹¹

In its filing, FINRA explained that OTC Market Makers currently are not required to display a customer limit order unless doing so would comply with the minimum quotation sizes applicable to the display of quotations on an inter-dealer quotation system.¹² FINRA noted that, although a customer limit order may improve price or size by more than a de minimus amount, if the order is for an amount less than the minimum quotation size set forth in the Rule, the member is not required to display the order. FINRA believed that the proposed rule change would benefit investors by facilitating the display of customer limit orders under FINRA Rule 6460, which generally requires that OTC Market Makers fully display better-priced customer limit orders (or same-priced customer limit orders that are at the best bid or offer and that increase the OTC Market Maker’s size by more than a de minimus amount).¹³

Specifically, FINRA proposed that the minimum quotation size required for display of a quotation in an OTC Equity Security would fall into one of six tiers rather than the current nine tiers. Under the current rule, the tiers are as follows:

- \$2500.01 per share and above, the minimum quotation size is 1 share;

Security in any inter-dealer quotation system, including any system that the SEC has qualified pursuant to Section 17B of the Act. A member is an OTC Market Maker only in those OTC Equity Securities in which it displays market making interest via an inter-dealer quotation system.” See FINRA Rule 6420(f).

¹¹ See Notice, supra note 5.

¹² See Regulatory Notice 10-42 (September 2010).

¹³ FINRA Rule 6460 was adopted as part of an effort to extend certain protections in place for NMS stocks to quoting and trading of OTC Equity Securities. See NMS-Principled Rules Approval Order, supra note 4. In approving FINRA Rule 6460, the Commission noted 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.” Id.

- \$1000.01 through \$2500 per share, the minimum quotation size is 5 shares;
- \$501.01 through \$1000 per share, the minimum quotation size is 10 shares;
- \$200.01 through \$500 per share, the minimum quotation size is 25 shares;
- \$100.01 through 200 per share, the minimum quotation size is 100 shares;
- \$10.01 through \$100 per share, the minimum quotation size is 200 shares;
- \$1.01 through \$10.00 per share, the minimum quotation size is 500 shares;
- \$0.51 through \$1.00 per share, the minimum quotation size is 2,500 shares;
- \$0.0001 through \$0.50 per share, the minimum quotation size is 5,000 shares.

Under the new proposal, the tiers are as follows:

- \$175.00 per share and above, the minimum quotation size would be 1 share;
- \$1.00 through \$174.99 per share, the minimum quotation size would be 100 shares;
- \$0.51 through \$0.9999 per share, the minimum quotation size would be 200 shares;
- \$0.26 through \$0.5099 per share, the minimum quotation size would be 500 shares;
- \$0.02 through \$0.2599 per share, the minimum quotation size would be 1,000 shares;
- \$0.0001 through \$0.0199 per share, the minimum quotation size would be 10,000 shares.

Based on its study of the Order Audit Trail System (“OATS”) data for OTC Equity Securities, as described in the Notice, FINRA believed that the proposed modification to the current tiers would result in the display of a larger number of customer limit orders, potentially

increasing from 50% to 90% the number of customer limit orders eligible for display in some tiers.¹⁴ FINRA stated that, for securities priced at or above \$0.02 per share, the reduction in minimum quotation size requirements would cause a greater percentage of customer limit orders to be displayed, and that the proposal would continue to require that displayed quotations represent a minimum aggregate dollar value commitment to the market.¹⁵

FINRA believed that the proposed revisions are appropriate because they would simplify the price and size tier structure of FINRA Rule 6433 and would facilitate the display of customer limit orders consistent with FINRA Rule 6460, while still recognizing the utility of requiring that quotes in lower-priced securities represent a minimum dollar-value commitment to the market. FINRA also believed that the proposed revisions would benefit investors by increasing the percentage of customer limit orders that would be eligible for display under Rule 6460, thereby improving transparency and enhancing execution of customer limit orders.

Further, FINRA proposed to expand the scope of the Rule to apply to all quotations or orders displayed in an inter-dealer quotation system, including quotations displayed by alternative trading systems (“ATs”) or those representing customer trading interest. FINRA noted that ATs have become increasingly active in the over-the-counter (“OTC”) markets and believed that the expansion of the scope of the Rule would ensure that minimum quotation sizes were observed consistently by all members displaying quotations on an inter-dealer quotation system. Finally, FINRA noted that the proposed rule would incorporate the requirements of FINRA Rule 6434 (Minimum Pricing Increments for OTC Equity Securities), which, among other things, prohibits members from displaying a bid or offer in an OTC Equity Security in an

¹⁴ See Notice, *supra* note 5.

¹⁵ *Id.* For securities priced under \$0.02 per share, FINRA recognized that more substantive dollar-value commitments to the market would be required.

increment smaller than \$0.01 if the bid or offer is priced \$1.00 or greater per share, or in an increment smaller than \$0.0001 if the bid or offer is priced below \$1.00.¹⁶

FINRA remarked that other existing requirements and obligations are not being altered by its proposal. Each member would continue to be required to honor its quotations to the full quantity displayed in accordance with FINRA Rule 5220 (Offers at Stated Prices), which generally provides that no member shall make an offer to buy or sell any security at a stated price unless such member is prepared to purchase or sell the security at such price and under such conditions as are stated at the time of such offer to buy or sell.¹⁷ Likewise, member obligations pursuant to FINRA Rule 5210 (Publication of Transactions and Quotations) continue to apply. Among other things, FINRA Rule 5210 generally prohibits members from publishing, circulating, or causing to be published or circulated, any quotation which purports to quote the bid price or asked price for any security, unless such member believes that such quotation represents a bona fide bid for, or offer of, such security.¹⁸

III. Comment Letters

The Commission received seven comment letters on the proposal from four commenters.¹⁹ In addition, FINRA submitted two responses to the comment letters.²⁰ Commenters generally were supportive of the goal of making additional limit orders eligible for display under FINRA Rule 6460. However, two commenters, in five separate letters, objected to

¹⁶ See FINRA Rule 6460(b)(8).

¹⁷ See also Rule 5220.01 (Firmness of Quotations).

¹⁸ See also Rule 5210.01 (Manipulative and Deceptive Quotations).

¹⁹ See supra note 6.

²⁰ See supra note 7.

the portion of the proposed rule that would revise the minimum quotation size requirements.²¹ Specifically, these commenters expressed concern that FINRA's proposal lacks sufficient economic analysis to demonstrate that the proposed revisions to the minimum quotation size requirements would improve liquidity or lower transaction costs for investors. On the other hand, one commenter suggested that FINRA consider reducing the tier sizes for minimum quote sizes even further than proposed in order to provide greater transparency to all market participants.²² One commenter supported the Rule to the extent that it would help prevent manipulative practices, but otherwise addressed topics unrelated to the proposal.²³

One commenter expressed the view that the proposal could have the unintended consequence of negatively impacting the market by removing meaningful minimum required dollar value levels of displayed liquidity by market makers.²⁴ According to the commenter, because the proposed levels are significantly lower than currently required levels, the proposal potentially could cause a severe degradation in trading efficiency, particularly in less liquid securities, and thereby fail to meet the proposal's desired goal.²⁵ The commenter provided a table to detail the change to the minimum dollar value required to be displayed by market makers under the proposal.²⁶ The commenter believed that its table illustrated a significant decrease in dollar value of liquidity that market makers would be required to offer at each tier level.

²¹ See OTC Markets Letter I, Knight Letter I, OTC Markets Letter II, OTC Markets Letter III, and Knight Letter II.

²² See Shatto Letter.

²³ See Hamlet Letter.

²⁴ See Knight Letter I.

²⁵ See Knight Letter I at p.1.

²⁶ See Knight Letter I at p.2.

In addition, the commenter believed that, under the proposal, market makers would be required to quote insignificant dollar values, thereby creating additional operational and trading risks, without providing real value to the market.²⁷ The commenter further expressed concern that any increase in costs to market making liquidity providers could result in the departure of market makers and thereby could cause an erosion of liquidity.²⁸ The commenter recommended further economic analysis to study the expected impact of the proposed tier sizes on market liquidity (including trading, clearing, related costs, locked markets, access fees, trading efficiency and market participant behavior), and requested that the Commission conduct an analysis of the data.²⁹ The commenter suggested that, if the Commission were inclined to move forward after such analysis, a limited pilot would allow for the assessment of the proposal's impact on market quality while minimizing the effects of any unintended consequences.³⁰

In another communication, the commenter reiterated its belief that the proposal would have serious negative consequences to the OTC marketplace and investors, including a significant reduction in liquidity, inferior pricing and increased vulnerability to gaming and frontrunning.³¹ The commenter expressed concern about the consequences likely to result when concepts and rules from the NMS market were applied to the OTC market despite different trading characteristics between NMS securities and OTC equity securities.³² The commenter again requested that the Commission evaluate the costs and benefits associated with the

²⁷ See id.

²⁸ See id.

²⁹ See id.

³⁰ See id.

³¹ See Knight Letter II at p.1. The commenter noted its agreement with the views expressed in OTC Markets Letter III. Id. The commenter also included a modified version of the table that was in its prior letter. See Knight Letter II at p.3.

³² See id.

proposal.³³ The commenter pointed to the prior analysis by the National Association of Securities Dealers, Inc., FINRA's predecessor, in connection with tier size reductions in Nasdaq securities and suggested that FINRA consider a similar approach for the current proposal.³⁴

The commenter expressed the view that non-NMS securities are significantly less liquid than NMS securities and that the proposed rule change would have an adverse impact on both dealers and investors.³⁵ The commenter believed that the only possible benefits resulting from the proposal would accrue to firms that provide little or no liquidity, as those firms would pick-off dealer liquidity at the expense of investors.³⁶ The commenter further noted that market makers like Knight generally do not charge competitors or broker-dealer clients commissions or mark-up/mark-downs.³⁷ The commenter indicated that market makers would continue to pay costs to access liquidity under the proposal and that there was a likelihood that market participants would gravitate to posting quotations at the minimum tier size as they currently do today.³⁸ Finally, the commenter reiterated its concern that costs could increase for self-clearing firms under the proposal and that costs would be more burdensome in the case of non-DTCC eligible securities (physicals) because those costs were driven by the number of settlements as opposed to number of trades.³⁹

³³ See Knight Letter II at p.2.

³⁴ See id. (citing Securities Exchange Act Release No. 40211 (July 15, 1998), 63 FR 39322 (July 22, 1998) (Order Approving a Proposed Rule Change to Permanently Expand the NASD's Rule Permitting Market Makers to Display Their Actual Quotation Size)).

³⁵ See Knight Letter II at pp.2-3.

³⁶ See Knight Letter II at p.3.

³⁷ See id.

³⁸ See id.

³⁹ See Knight Letter II at pp.3-4.

Another commenter expressed the view that the reduction of minimum quote size requirements “has not been shown by FINRA to benefit investors and has a significant risk that it will degrade market quality.”⁴⁰ The commenter further suggested that Regulation NMS-type rules are not appropriate in the context of smaller issuers.⁴¹ The commenter believed that the immediate effect of the proposal would be less displayed liquidity, even if the actual liquidity were larger, because quotations typically are submitted at the minimum size.⁴² The commenter believed that this potential effect would lead to more volatility and would increase realized spreads because orders ultimately would be filled away from the inside quote, thereby raising the cost of trading.⁴³

The commenter believed that the analysis provided by FINRA was not compelling, and cited to public commentators that generally have suggested other Regulation NMS-principled rules have harmed the market for smaller companies’ securities.⁴⁴ The commenter asserted that FINRA’s statistical analysis concerning the additional percentage of customer orders that would be displayed under the proposed rule change was flawed, including because it ignored FINRA’s quote aggregation rules.⁴⁵ According to the commenter, at a minimum, FINRA’s analysis required further study.⁴⁶ The commenter recommended that the Commission’s staff review the actual effect of the proposed rule change on the display of limit orders.⁴⁷

⁴⁰ See OTC Markets Letter I at p.1.

⁴¹ See id.

⁴² See OTC Markets Letter I at p.3.

⁴³ See id.

⁴⁴ See OTC Markets Letter I at p.2.

⁴⁵ See id.

⁴⁶ See id.

⁴⁷ See OTC Markets Letter I at p.3.

In another communication, the commenter again expressed concern that FINRA’s analysis was flawed.⁴⁸ The commenter suggested that the proposal represented a large change in market structure and could negatively impact capital formation for small businesses. The commenter again requested that the Commission’s staff conduct its own economic analysis concerning the proposed rule change.

The commenter reiterated its views in its third letter.⁴⁹ The commenter again stated its belief that Regulation NMS-type rules were not appropriate for the OTC market.⁵⁰ The commenter again suggested that FINRA’s analysis did not reflect existing customer order aggregation requirements;⁵¹ did not provide information regarding dollar and share volume relative to tier sizes;⁵² and did not analyze the proposal’s potential impact on market orders or proprietary quotes.⁵³

The commenter remarked that FINRA’s letters responding to the comment letters failed to address Section 3(f) of the Act,⁵⁴ which requires that whenever, pursuant to the Act, the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization (“SRO”), 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.⁵⁵ The

⁴⁸ See OTC Markets Letter II.

⁴⁹ See OTC Markets Letter III.

⁵⁰ See OTC Markets Letter III at p.5.

⁵¹ See OTC Markets Letter III at p.7.

⁵² See OTC Markets Letter III at p.8.

⁵³ See OTC Markets Letter III at pp.2-3.

⁵⁴ 15 U.S.C. 78c(f).

⁵⁵ See OTC Markets Letter III at pp.2-3.

commenter believed that changing tier sizes or quote increments potentially could have a variety of dynamic effects on the OTC market.⁵⁶ The commenter stated that it reviewed data relating to all trades in OTC equity securities that occurred on October 27, 2011, concerning share volume, dollar volume and number of trades in relation to the existing and proposed tier sizes.⁵⁷ Based on its review, the commenter believed that the proposed rule would not significantly increase liquidity but would impose a direct cost on investors, particularly investors placing marketable orders.⁵⁸ The commenter believed that the proposed rule change would lead most market makers to reduce their quote sizes and display less liquidity.⁵⁹ The commenter further believed that an extensive decrease in displayed proprietary liquidity would “overwhelmingly offset the benefit of the increased number of customer limit orders displayed.”⁶⁰

FINRA provided two responses addressing issues raised by the commenters.⁶¹ In both of its responses, FINRA noted that the purpose of allowing smaller displayed quotes was to allow for the greater use of limit orders by investors.⁶² In FINRA Response II, FINRA reiterated that the proposed rule change was associated with the FINRA limit order display rule, which recently had extended a fundamental investor protection to OTC equity securities.⁶³ FINRA explained that the existing minimum quotation sizes reduced the benefit of its limit order display rule

⁵⁶ See OTC Markets Letter III at p.4.

⁵⁷ See OTC Markets Letter III at p.5. The commenter selected October 27, 2011 for its review, because that day had the highest trading volume of any day that month and, according to the commenter, presumably also had the highest amount of investor liquidity for that month.

⁵⁸ See OTC Markets Letter III at p.6.

⁵⁹ See id.

⁶⁰ See OTC Markets Letter III at p.7.

⁶¹ See supra note 7.

⁶² See FINRA Response I at p.1.

⁶³ See FINRA Response II at p.1.

because the higher existing levels “act to restrict transparency of a large number of customer limit orders.”⁶⁴ Addressing commenters’ concerns about reduced liquidity, FINRA noted that the lower minimum quote size would allow for the display of a greater number of limit orders. FINRA believed that the larger number of quotes would increase competition, and increased competition would improve liquidity.⁶⁵ FINRA noted that, although the role of the market maker had been reduced in NMS securities, liquidity in NMS securities appeared intact.⁶⁶

FINRA noted that, to the extent commenters had concerns that processing smaller quotes would not be economical, the proposed rule change would not mandate the use of smaller quote sizes.⁶⁷ In FINRA Response I, FINRA questioned the notion of the proposal resulting in additional costs to process additional orders and added that, to the extent that the proposed rule might result in additional transactions, the costs of clearing such additional transactions would be negligible.⁶⁸ FINRA further remarked that, with respect to other concerns about transaction costs, FINRA’s mark-up rule, which governs execution costs, is still applicable and is not being modified by the instant proposal.⁶⁹

In FINRA Response II, FINRA disagreed with one commenter’s suggestion that the percentage of customer limit orders currently displayed under the FINRA limit order display rule

⁶⁴ Id.

⁶⁵ See FINRA Response I at p.1 and FINRA Response II at p.5, n.17. Two commenters stated that market makers might react to the proposed rule change by reducing their quote sizes. See Knight Letter I at p.1-2 and OTC Markets Letter I at p.3.

⁶⁶ See FINRA Response I at p.1.

⁶⁷ See FINRA Response I at p.1 and FINRA Response II at p.5, n.17. One commenter believed there would be costs associated with the operational complexity of clearing increased volumes of smaller trades in non-DTC eligible securities. See Knight Letter I at p.2.

⁶⁸ See FINRA Response I at p.1. One commenter believed that the proposed rule change would increase transaction costs for investors. See OTC Markets Letter I at p.3.

⁶⁹ See FINRA Response I at p.1.

already was in line with FINRA's estimate of the number of customer limit orders that would be displayed under the proposal.⁷⁰ FINRA believed that, contrary to the commenter's assertion, broker-dealers were unlikely to be in a position to aggregate multiple investor OTC equity orders to reach the existing display thresholds, because OTC equity securities trade infrequently and at widely varying volume each day.⁷¹ FINRA also noted that, in any event, price transparency should not depend upon the expectation that other OTC orders might be placed at the same price and around the same time.⁷² Finally, FINRA noted that a more recent sample of relevant data further supported its position that the proposed rule change would increase the display of customer limit orders from 50% under the existing minimum quotation size requirements to 90% under the proposal.⁷³

In FINRA Response II, FINRA stated its view that the chart contained in Knight Letter I was not useful because that the chart did not accurately align tier and price points and therefore did not allow for an appropriate comparison of the current and proposed rules.⁷⁴ FINRA provided a comparison of similar price points and ranges to demonstrate that the proposed rule change would increase the dollar values for two proposed lower price point tiers and decrease dollar values for three proposed higher price point tiers, while the dollar values of one proposed price point tier would remain unchanged.⁷⁵ FINRA believed that its proposed structure was better for investors, more consistent with the national market system, and represented more

⁷⁰ See FINRA Response II at p.3. One commenter believed that the FINRA analysis failed to take into account aggregation requirements. See OTC Markets Letter I at p.2.

⁷¹ See FINRA Response II at p.3.

⁷² See id.

⁷³ See id.

⁷⁴ See FINRA Response II at pp.3-4.

⁷⁵ See FINRA Response II at p.4.

meaningful minimum displayed liquidity at the lowest tiers.⁷⁶ FINRA disagreed with the suggestion in Knight Letter I that its proposal would degrade market quality or have far reaching effects on liquidity and efficiency in the OTC markets, noting again that the commenters provided no supporting data linking these alleged harms with the proposed rule change.⁷⁷ FINRA reiterated that the likely impact of the proposed rule change would be greater displayed customer limit orders, as customer orders may be smaller than market maker orders, and that this increased display would result in increased price transparency.⁷⁸ FINRA noted that the Rule only prescribes the minimum sizes required for display, and that market makers may choose to display a quotation at the proposed minimum or in excess of the proposed minimum, as they do today.⁷⁹

In FINRA Response II, FINRA further noted that several comments were not germane to the consideration of the merits of its proposal. For example, FINRA did not believe that there was a nexus between the proposed rule and the extension of certain other national market protections to OTC markets, as stated in the OTC Markets comments,⁸⁰ or between the proposed rule and the problems of locked or crossed markets, access fees or other issues, as suggested by Knight Letter I.⁸¹

⁷⁶ See id.

⁷⁷ See FINRA Response II at pp.4-5.

⁷⁸ See FINRA Response II at pp.5-6.

⁷⁹ See FINRA Response II at p.6; see also FINRA Response I at p.1.

⁸⁰ See FINRA Response II at p.6. One commenter believed “NMS-type rules are harmful when applied to smaller companies.” See OTC Markets Letter I at pp.1-2.

⁸¹ See FINRA Response II at p.6. As noted above, one commenter requested that the Commission examine the impact on trading, clearing (e.g., the operational complexity of clearing increased volumes of smaller trades in non-DTC eligible securities), related costs, locked markets, access fees, trading efficiency and market participant behavior under the proposed reduced tier sizes. See text accompanying note 29 supra.

Finally, FINRA Responses I and II also addressed the comment process more broadly. In FINRA Response I, FINRA stated that Knight Letter I and OTC Markets Letter I made “unsupported, at points unrelated and somewhat vague comments that on their face raise questions and ask the Commission to do the commenter’s homework.”⁸² FINRA remarked that the “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.”⁸³ FINRA stated that no SRO is required to undertake an economic analysis of its rule proposals.⁸⁴ FINRA stated that the standards for approving proposed rule changes are set forth in the Act and should not be modified arbitrarily.⁸⁵ FINRA believed that a comment lacking a sufficient basis to demonstrate a connection between the proposal and market quality should not factor into the Commission’s approval process.⁸⁶ FINRA indicated its view that it would be inappropriate for the Commission to give undue weight to unsupported assertions in evaluating the proposed rule change.⁸⁷

IV. Proceedings to Determine Whether to Disapprove SR-FINRA-2011-058 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act⁸⁸ to determine whether the proposed rule change should be disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues that are raised by the proposal and are discussed below. Institution of disapproval proceedings does not indicate that

⁸² See FINRA Response I at p.2.

⁸³ Id.

⁸⁴ See FINRA Response II at p.7.

⁸⁵ See id.

⁸⁶ See FINRA Response II at pp.7-8.

⁸⁷ See FINRA Response II at p.7.

⁸⁸ 15 U.S.C. 78s(b)(2)(B).

the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change to inform the Commission's analysis whether to approve or disapprove the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act, the Commission is providing notice of the grounds for disapproval under consideration. In particular, Section 15A(b)(6) of the Act⁸⁹ requires that the rules of the association be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. In addition, Section 15A(b)(11) requires that FINRA rules include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied.⁹⁰

FINRA's proposal would adjust the minimum quotation size requirements in FINRA Rule 6433 to simplify the Rule's tier structure; facilitate the display of customer limit orders; and expand the scope of the Rule to cover quotations by ATSS or quotations representing customer trading interest that are displayed in an inter-dealer quotation system. FINRA believes that its proposal would benefit investors of OTC equity securities because the proposed revisions to the Rule's tier structure would result in the display of a greater number of customer limit orders for these securities than currently occurs under the Rule. In FINRA's view, the benefits to investors are reduced if the Rule's minimum quotation sizes are too high and thus act to restrict

⁸⁹ 15 U.S.C. 78o-3(b)(6).

⁹⁰ 15 U.S.C. 78o-3(b)(11).

transparency for customer limit orders for OTC equity securities. FINRA based its conclusion that a larger number of customer limit orders would be displayed under its proposal on its analysis of a recent sample of OATS data.

Two commenters favored the proposal. On the other hand, the commenters that are an OTC market maker and an inter-dealer quotation system, respectively, disputed the need to revise the Rule's current tier structure. One of these commenters argued that FINRA has not adequately demonstrated that revisions to the minimum quotation size requirements for OTC equity securities would benefit investors and instead countered that the proposal would degrade the quality of the market for these securities. The other commenter that objected to the proposal believed that the proposal could impact market liquidity and increase costs to market makers, which could result in market makers' departure from the OTC market. Both of these commenters urged that the Commission undertake an economic analysis of the anticipated effects of the proposal as part of its consideration and suggested that, if the Commission decided to move forward on the proposal, it should consider placing the proposed changes to the Rule's tier structure on a pilot program.

The Commission believes that questions are raised as to whether FINRA's proposal is consistent with the requirements of Section 15A(b)(6) of the Act, including whether the proposed adjustments to the minimum quote size requirements would prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest, and with the requirements of Section 15A(b)(11) of the Act, including whether the proposed rule change would produce fair and informative quotations, prevent fictitious or misleading quotations, and promote orderly procedures for collecting,

distributing, and publishing quotations. While investors who place customer limit orders that are smaller in size than the Rule's current minimum quotation size requirements would benefit from the proposed revisions, market quality for OTC equity securities potentially could be affected if the proposed tier sizes are not calibrated appropriately. The Commission believes that the issues raised by the proposed rule change can benefit from additional consideration and evaluation.

VI. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data and arguments with respect to the concerns identified above, as well as any others they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is inconsistent with Sections 15A(b)(6) and 15A(b)(11) or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.⁹¹

Interested persons are invited to submit written data, views and arguments regarding whether the proposed rule change should be disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register].

⁹¹ Section 19(b) (2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2011-058 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2011-058. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-FINRA-2011-058 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁹²

Kevin M. O'Neill
Deputy Secretary

⁹² 17 CFR 200.30-3(a)(57).