Regulatory Notice 14-46

November 2014

Equity Trading Initiatives: OTC Trade Sequencing

FINRA Requests Comment on a Proposal to Identify OTC Equity Trades Reported More Than Two Seconds After Execution as "Out of Sequence" and Not Last Sale Eligible

Comment Period Expires: Friday, January 9, 2015

Executive Summary

FINRA requests comment on a proposal to identify over-the-counter (OTC) trades in NMS stocks reported more than two seconds following trade execution as "out of sequence" and not last sale eligible for public dissemination purposes.

The proposed rule text is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Dave Chapman, Director, Market Regulation, at (240) 386-4995;
- Brendan Loonam, Director, Business Services, at (212) 858-4203; or
- Lisa Horrigan, Associate General Counsel, Office of General Counsel, at (202) 728-8190.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by Friday, January 9, 2015.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

FINRA
Financial Industry Regulatory Authority

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Systems
- Trading

Key Topics

- Alternative Display Facility
- Dissemination
- Last Sale Eligible Trades
- NMS Stocks
- OTC Equity Securities
- OTC Reporting Facility
- Securities Information Processors (SIPs)
- Tape Reports
- Trade Reporting
- Trade Reporting Facilities

Referenced Rules & Notices

- FINRA Rule 6282
- FINRA Rule 6380A
- FINRA Rule 6380B
- FINRA Rule 6622

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.[1]

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the SEA.[2]

Background & Discussion

The proposal set forth in this *Notice* is one of seven FINRA initiatives relating to equity market structure and automated trading activities including high frequency trading (HFT).[3] These initiatives are designed to increase the scope of trading information FINRA receives, provide more transparency into trading activities to market participants and investors and require firms engaged in electronic trading and their employees to be trained, educated and accountable for their role in equity trading.

Under FINRA trade reporting rules, OTC trades in NMS stocks—as well as OTC equity securities (*i.e.*, non-NMS stocks such as OTC Markets and foreign securities)—that are executed during the hours that a FINRA facility is open, must be reported as soon as practicable, but no later than 10 seconds, following trade execution.[4] Trades reported more than 10 seconds following execution are late for purposes of compliance with FINRA rules and public dissemination. As such, these trades are not "last sale" eligible, *i.e.*, they do not update the last sale price disseminated by the securities information processors (SIPs).[5]

Given the increasing speed of trading in today's automated markets, particularly with respect to HFT algorithms, FINRA believes that a period of 10 seconds for last sale eligibility is too long to ensure proper sequencing of trades, especially given that trades electronically executed on an exchange, which are disseminated through the same SIPs as OTC trades in NMS stocks that are reported to FINRA, generally are reported electronically within sub-seconds. Trades are disseminated in the order in which they are reported, and the consolidated market data that is publicly disseminated by the SIPs does not distinguish between a trade reported one second after execution and a trade reported 10 seconds after execution, as both are considered timely. Thus, given how quickly the market and price for a security can change, even though the vast majority of trades are reported within one or two seconds today, the marketplace is unable to discern which trades reflect the immediate current market.

For example, Firm 1 executes an OTC trade in ABCD security at 10:00:00 a.m. at a price of $20.00 per share and reports the trade at 10:00:10; this trade is timely under FINRA rules and currently eligible to update the last sale price. Firm 2 executes a trade in the same security at 10:00:05 a.m. at a price of $21.00 per share and reports the trade at 10:00:06. Firm 2's trade, because it was reported first, will be disseminated prior to Firm 1's trade. A market participant viewing the consolidated market data at 10:00:10 could misconstrue the current market for ABCD security to be $20.00 rather than $21.00.

In addition, because trades executed 10 seconds prior may no longer reflect the current market for actively traded stocks, they may improperly impact the calculation of reference prices under the NMS Plan to Address Extraordinary Market Volatility (also referred to as the Limit Up/Limit Down Plan) or, at an extreme, trigger a trading halt. Delayed reports also could appear to other market participants as a violation of the Regulation NMS Order Protection Rule (*i.e.*, trading at a price worse than the best displayed bid or offer, commonly referred to as a "trade-through").[6]

Accordingly, FINRA is proposing to identify OTC trades in NMS stocks reported more than two seconds following trade execution as "out of sequence" for public dissemination purposes and therefore not last sale eligible.[7] The FINRA trade reporting facilities, *i.e.*, the Alternative Display Facility (ADF) and the Trade Reporting Facilities (TRFs),[8] will append an indicator to "out of sequence" trades before sending them to the SIPs for dissemination. Thus, in the example above, Firm 1's trade in ABCD security would be identified as "out of sequence" and would not update the last sale price, and a market participant viewing the consolidated market data at 10:00:10 would see the current market for ABCD security reflected as $21.00.

The current trade reporting timeframe under FINRA rules will remain unchanged. Thus, firms will continue to be required to report OTC trades as soon as practicable, and only trades reported more than 10 seconds following execution will continue to be considered late for purposes of compliance with FINRA rules. As such, FINRA believes that the proposal will minimize the impact on firms. For example, if the trade reporting timeframe under FINRA rules were reduced to two seconds, some firms would be required to undertake systems development work to comply with the new requirement.

FINRA believes that the proposal will reduce the likelihood that out of sequence trades will be misconstrued and will increase the reliability of the transaction reporting stream, which will improve the ability of investors to understand the market conditions prevailing at the time of execution of their orders. FINRA further believes that two seconds strikes the appropriate balance of retaining most trades in the last sale calculation while excluding those that may not accurately reflect the current market. For example, during the period of June 23 through June 27, 2014, 97.330 percent of OTC trades in NMS stocks were reported within two seconds of execution.[9] By way of comparison, during this period, 91.276 percent of OTC trades in NMS stocks were reported within one second of execution and 98.729 percent were reported within three seconds of execution.

FINRA considered whether a separate standard should apply to thinly traded securities, *e.g.*, whether trades in thinly traded securities reported within 10 seconds of execution should continue to be eligible to update the last sale price. However, FINRA is concerned that it may be difficult to define the universe of "thinly traded securities" and to apply such definition in a consistent and meaningful way. Additionally, FINRA is concerned that separate standards could be difficult to administer from a systems perspective and confusing for market participants (*i.e.*, the tape would not identify trades subject to a two-second versus a 10-second standard, without additional systems development work, and thus market participants would need to refer to a list of securities that qualify as "thinly traded," which would change over time). Under the proposal, trades reported more than two seconds following execution will continue to be included in trade information disseminated by the SIPs, which is available to investors and other market participants, and will continue to be eligible to update the high and low sale prices for the day. Accordingly, FINRA believes that the proposal should apply to all NMS stocks uniformly. Nonetheless, FINRA specifically seeks comment on this issue.

Much of the discussion relating to HFT has focused on the NMS stock markets. The OTC equity securities market is not as fully automated as the NMS stock markets and more manual trading and reporting occur in OTC equity securities. Proper sequencing of trades and the reliability of the transaction reporting stream also are important in the OTC equity securities market. However, given the more manual nature of this market, the fact that the market for an OTC equity security may not change as quickly as for actively traded NMS stocks, and the absence of some of the concerns underlying the proposal (*e.g.*, the need for proper sequencing of trades for Limit Up/Limit Down and Regulation NMS purposes), at this time FINRA is not proposing that trades in OTC equity securities reported more than two seconds following execution be identified as "out of sequence" for purposes of public dissemination. (Trades in OTC equity securities are not commingled with transactions in NMS stocks, but are disseminated separately via FINRA's Trade Data Dissemination Service (TDDS) feed.) However, FINRA specifically seeks comment on this issue.

FINRA also is proposing to amend the current Supplementary Material that provides guidance on the "as soon as practicable" requirement under the trade reporting rules. Specifically, consistent with the SEC's application of Rule 603 of Regulation NMS,[10] FINRA interprets the "as soon as practicable" requirement to also require that firms not disseminate executed trade information sooner than the trade is reported to FINRA. Thus, for example, an ATS cannot commence the process of disseminating trade information to its subscribers any faster than it commences the process of reporting the trade to FINRA for dissemination purposes. This also would prohibit an ATS from reporting back execution information to the subscriber on whose behalf the trade was executed sooner than it reports the information to FINRA.

Economic Impacts

Anticipated Benefits

As discussed above, FINRA believes that the proposal would enhance the trade information disseminated on the tapes, thereby enabling investors and other market participants to better understand the market conditions prevailing at the time of execution of their orders. The proposal would also reduce the likelihood that out of sequence trades are misinterpreted or, for example, improperly impact the calculation of reference prices under the Limit Up/Limit Down Plan.

The economic impacts of the proposal may vary across securities depending upon the frequency at which the underlying securities trade. The anticipated benefits would be most pronounced with respect to more actively traded securities. For securities that are very thinly traded, FINRA considered whether the proposal would result in a loss of information, since some trades may be excluded from the last sale price calculation. FINRA notes that this may be an issue today, *i.e.*, for very thinly traded securities where there is usually more than 10 seconds between trades, potentially the only trade that would update the last sale price is already omitted from the last sale calculation, if it is not reported within 10 seconds. However, FINRA does not believe that the proposal would result in a material loss of information because the trades would still be included in the data that is publicly disseminated and would continue to update the high and low sale prices. Nonetheless, FINRA specifically solicits comment on this issue.[11]

In addition, the proposal to amend the Supplementary Material relating to the "as soon as practicable" requirement would clarify the need for consistency in the timeliness of reporting of information to ATS subscribers and other market participants via FINRA. As noted above, the proposed amendments would clarify that, consistent with the SEC's application of Rule 603 of Regulation NMS, a firm must not disseminate trade information to subscribers prior to meeting its reporting requirements to FINRA.

Anticipated Costs

The proposal would not change a firm's reporting obligations under FINRA rules and, as a result, would impose no material direct costs to member firms. In addition, the costs to FINRA would be minimal to update the TRFs and the ADF to identify "out of sequence" trades before sending them to the SIPs for dissemination.

Request for Comment

FINRA seeks comments on the proposal outlined above. In addition to general comments, FINRA specifically requests comments on the following questions:

- Would the proposal enhance the trade information disseminated on the tapes?
- Is the proposed two-second threshold for last sale eligibility for OTC trades in NMS stocks appropriate? If not, what alternative would commenters propose and why?
- As noted above, trades that are marked "out of sequence" and not last sale eligible will still be available to investors and other market participants. Nonetheless, are there concerns that the proposal could mischaracterize some trades, for example, those involving thinly traded stocks?
  - Should FINRA consider a separate threshold for thinly traded securities, and if so, how should the universe of "thinly traded" securities be defined?
  - Would such an approach provide more meaningful information to the marketplace? Is there a risk that separate thresholds could cause confusion to market participants?
- Because the ADF and TRFs would append the indicator before sending transaction reports to the SIPs, FINRA believes that the proposal would have minimal impact on firms. Do firms agree?
  - Are there any direct or indirect costs that firms may incur as a result of the proposal, and if so, what are they?
  - Do firms anticipate having to make any systems changes as a result of the proposal? If so, what are the costs associated with these system changes?
- The proposal would apply only to NMS stocks. Do commenters believe that it should be expanded to also apply to trades in OTC equity securities reported to the OTC Reporting Facility? If so, why, and what are the associated economic impacts?

FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NTM 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

2. *See* Section 19 of the Securities Exchange Act of 1934 (SEA) and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. *See* FINRA September 19, 2014, News Release "FINRA Board Approves Series of Equity Trading and Fixed Income Rulemaking Items."

4. Firms must have policies and procedures reasonably designed to comply with the "as soon as practicable" requirement and must implement systems that commence the trade reporting process without delay upon execution. Where a firm has such reasonably designed policies, procedures and systems in place, the firm will not be viewed as violating the "as soon as practicable" requirement because of delays in trade reporting due to extrinsic factors that are not reasonably predictable and where the firm does not purposely intend to delay the reporting of the trade.

5. Trades reported for public dissemination purposes are transmitted to three "tapes" based on the listing venue of the security: New York Stock Exchange securities (Tape A), NYSE Arca, NYSE MKT and other regional exchange securities (Tape B), and Nasdaq Stock Market securities (Tape C). Tape A and Tape B are governed by the Consolidated Tape Association Plan (CTA Plan) and Tape C is governed by the Nasdaq Unlisted Trading Privileges Plan (UTP Plan). The consolidated tapes disseminate information for trades in NMS stocks executed OTC, as well as trades executed on exchanges.

6. For example, if a trade is not disseminated until 10 seconds after execution, the best displayed market could have changed dramatically between the time of execution and ultimate dissemination of the trade, giving the appearance of a trade-through of the then-current market.

7. Of course, for inactive stocks with gaps between trades of more than 10 seconds, these trades may in fact be in sequence. Generally, this would be apparent in the trade data.

8. FINRA has two TRFs: the FINRA/NASDAQ TRF and the FINRA/NYSE TRF.

9. As noted above, market participants have no way to identify which trades on the tape were reported within two seconds of execution and which trades were reported within 10 seconds of execution, and the price could have changed dramatically within that period. Thus, although the vast majority of trades are reported within two seconds today, FINRA is concerned that out of sequence trades nonetheless may be misconstrued.

10. Rule 603 provides that any national securities exchange, national securities association, broker, or dealer that distributes information with respect to quotations for or transactions in an NMS stock to a securities information processor, broker, dealer, or other persons shall do so on terms that are not unreasonably discriminatory.

11. FINRA also considered whether a firm might alter its reporting patterns by, for example, selectively reporting some trades in more than two seconds so as not to update the last sale price, while reporting its remaining trades within two seconds. Such behavior would be a violation of the trade reporting rules, and as such, FINRA believes that any such concerns are mitigated.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

Note: The text of the proposed amendments to FINRA Rule 6380A relating to the FINRA/NASDAQ TRF is shown below. Similar changes will be made to the rule series relating to the ADF and FINRA/NYSE TRF.

6000. QUOTATION AND TRANSACTION REPORTING FACILITIES

* * * * *

6300. TRADE REPORTING FACILITIES

6300A. FINRA/NASDAQ TRADE REPORTING FACILITY

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6380A. Transaction Reporting

(a) through (h) No Change.

• • • Supplementary Material: --------------

.01. No Change.

.02 Trade Reporting Time Frame

(a) With respect to the requirement under paragraphs (a) and (g) of this Rule that members report trades and trade cancellations "as soon as practicable," a member with the trade reporting obligation under paragraph (b) of this Rule must adopt policies and procedures reasonably designed to comply with this requirement and must implement systems that commence the trade reporting process without delay upon execution (or cancellation, as applicable). Where a member has such reasonably designed policies, procedures and systems in place, the member generally will not be viewed as violating the "as soon as practicable" requirement because of delays in trade reporting that are due to extrinsic factors that are not reasonably predictable and where the member does not purposely intend to delay the reporting of the trade. In no event may a member purposely withhold trade reports, *e.g.*, by programming its systems to delay reporting until the last permissible second. <u>FINRA also interprets "as soon as practicable" to require members to disseminate trade information to other market participants no sooner than executed trade information is reported to FINRA for dissemination purposes.</u>

(b) No Change.

(c) For purposes of public dissemination, trades reported more than two seconds following execution will be submitted to the Securities Information Processors as "out of sequence" and will not be eligible to update the last sale price. Notwithstanding this designation, such trades will not be considered "late" if they are reported within the timeframe specified in paragraph (a) of this Rule.

.03 through .04 No Change.

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