Trade Reporting Notice

Trade Reporting Requirements Applicable to Step-Out Submissions

July 16, 2019

Key Topics

- Alternative Display Facility
- NMS Stocks
- OTC Equity Securities
- OTC Reporting Facility
- Step-Outs
- Trade Reporting
- Trade Reporting Facilities

Referenced Rules & Notices

- FINRA Rule 7130
- FINRA Rule 7230A
- FINRA Rule 7230B
- FINRA Rule 7330

Summary

FINRA is issuing this *Notice* to remind firms of their obligations when submitting step-outs to FINRA. While step-out submissions are voluntary and not required by rule, if firms elect to use a FINRA equity trade reporting facility to step out of a previously reported trade, they must comply with applicable trade reporting requirements.

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Discussion

The FINRA equity trade reporting facilities or "FINRA Facilities"[1] offer functionality for firms electing to submit step-outs for comparison, clearance and settlement through the National Securities Clearing Corporation (NSCC). A step-out allows a firm to allocate all or part of a client's position from a previously executed trade to the client's account at another firm. In other words, a step-out functions as a client's position transfer, rather than a trade. There is no exchange of shares and funds and no change in beneficial ownership. The FINRA Facilities designed and implemented the step-out function as a service to facilitate the clearing process for firms wanting to effect such transfers and to clear them through NSCC.

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To effect a step-out, a firm would submit a clearing-only (*i.e.*, not for public dissemination or "non-tape") report identified with the step-out indicator to a FINRA Facility. For example, Firm 1 purchases 10,000 shares of ABCD security on behalf of its customer. This trade is reported for public dissemination (or "tape") purposes. The customer instructs Firm 1 to step out of 4,000 shares of the position to the customer's account at Firm 2. To effect the step-out, Firm 1 would submit a non-tape/clearing-only report identified with the step-out indicator to allocate 4,000 shares of ABCD to the customer's account at Firm 2.

As noted above, step-outs are voluntary submissions and not required by FINRA rule. However, if a firm elects to use a FINRA Facility to effect a step-out, the firm must comply with all applicable trade reporting requirements, including those discussed below.

FINRA occasionally receives questions about the reporting requirements applicable to step-outs. This *Notice* is a reminder to firms of FINRA's previously published guidance on step-out submissions.[2]

- **Firms should not confuse step-outs with riskless principal and agency flips**

As noted above, a step-out allows a firm to transfer a client's position to the client's account at a different firm. The same client owns the accounts at both firms. As such, there is no change in beneficial ownership as a result of the step-out.

Step-outs are not the same as—and should not be confused with—riskless principal and agency "flips"; *i.e.*, the offsetting leg of a riskless principal or agency transaction between firms. Like step-outs, such flips can be effected by submitting a non-tape/clearing-only report to FINRA. However, unlike step-outs, riskless principal and agency flips entail a change in beneficial ownership and, in certain cases, are required by rule to be reported to FINRA.[3]

For example, Firm 1, as riskless principal on behalf of its customer, purchases 10,000 shares of ABCD security from Firm 2. The trade between Firm 1 and Firm 2 is reported for tape purposes. Assuming the transaction meets the riskless principal requirements under FINRA rules, Firm 1 submits a non-tape/clearing-only report to reflect the offsetting riskless leg between Firm 1 and its customer.[4] This leg is not the equivalent of a step-out and the non-tape/clearing-only report should not be designated as such.

- **Firms can only effect a step-out on the FINRA Facility to which the associated trade was reported for tape purposes**

Pursuant to FINRA rules, firms are permitted to step out of a trade on a FINRA Facility only if the trade was originally reported for tape purposes to that Facility.[5] Thus, firms are prohibited from submitting a step-out to a TRF relating to a trade executed on and reported through an exchange. Similarly, firms are prohibited from submitting a step-out to one TRF relating to a trade that was reported for public dissemination purposes to another TRF.[6]

For example, Firm 1 accumulates 10,000 shares of ABCD security for its customer by executing the following trades: four separate exchange trades for 2,000 shares each, one over-the-counter (OTC) trade for 1,000 shares that is reported to TRF A and one OTC trade for 1,000 shares that is reported to TRF B. The customer instructs Firm 1 to step out of those shares to the customer's account at Firm 2. Firm 1 can use TRF A to step out of the 1,000 share trade that was tape-reported to TRF A and can use TRF B to step out of the 1,000 share trade that was tape-reported to TRF B. Firm 1 cannot use a FINRA Facility to step out of the entire 10,000 share position.

- **Firms can only effect a step-out at the same execution price as the associated tape-reported trade**

Step-outs must be at the same execution price as the previously tape-reported trade. If Firm 1 buys 10,000 shares of ABCD at $10.00, Firm 1 can only step out of the position at an execution price of $10.00. A transaction effected at a different execution price than the original tape-reported trade is not a step-out.[7]

Firm 1 may, however, use the "explicit fee" functionality offered by the FINRA Facilities to transfer a transaction fee in connection with a step-out. For example, Firm 1 purchases 10,000 shares of ABCD at $10.00 on behalf of its customer, and the customer instructs Firm 1 to step out of 4,000 shares to the customer's account at Firm 2. Firms 1 and 2 have agreed that Firm 1 will charge a per share fee of $0.001 for this service. Firm 1 cannot include this fee in the execution price on the step-out submission. In other words, Firm 1 must report an execution price of $10.00 on the step-out submission and cannot report an execution price of $10.001. However, Firm 1 can use the "explicit fee" functionality offered by the FINRA Facility to report a step-out with an execution price of $10.00 and a clearing price of $10.001.[8]

- **Firms can only transfer a regulatory transaction fee if the firm is stepping out of an original sell transaction**

As part of a step-out submission, firms may elect to transfer the regulatory transaction fee assessed by FINRA pursuant to Section 3 of Schedule A to the FINRA Bylaws ("Section 3")[9] to another firm. However, firms may only transfer the Section 3 fee on a step-out when the firm stepping out of the position paid the fee on the original trade—*i.e.,* only when the firm is stepping out of an original sell transaction.[10]

For example, Firm 1 sells 10,000 shares of ABCD security on behalf of its customer to Firm 2 and steps out of 4,000 shares of the customer's position to Firm 3. Firm 1 is identified as the buyer and Firm 3 is identified as the seller on the step-out submission. In this example, the Section 3 fee can be transferred as part of the step-out. Firm 1 was on the sell side of the tape-reported trade and was originally assessed the Section 3 fee. Accordingly, the parties are permitted to designate a Section 3 fee transfer as part of the step-out from Firm 1 to Firm 3.

By contrast, suppose Firm 1 buys 10,000 shares of ABCD security on behalf of its customer from Firm 2 and steps out of 4,000 shares of the customer's position to Firm 3. Firm 1 is identified as the seller and Firm 3 is identified as the buyer on the step-out submission. In this example, the Section 3 fee cannot be transferred as part of the step-out. Firm 1 was on the buy side of the original tape-reported trade and thus was not originally assessed the Section 3 fee. Accordingly, the parties must not designate a Section 3 fee transfer as part of the step-out from Firm 1 to Firm 3.[11]

- **Firms should only use the "step-in" indicator if both sides are making a submission to effect the step-out**

For every step-out, one firm is stepping out of (or transferring) the position and the other firm is stepping into (or receiving) the position. Pursuant to FINRA rules, where both sides are submitting a non-tape/clearing-only report to effect a step-out, the firm transferring out of the position must report a step-out and the firm receiving the position must report a step-in. FINRA notes that the FINRA Facilities that offer trade matching (*i.e.*, the FINRA/Nasdaq TRFs, ADF and ORF) will match corresponding "step-out" and "step-in" submissions; the system will not match two "step-in" or two "step-out" submissions.[12]

For purposes of reporting step-outs/step-ins to the FINRA Facilities, the firm stepping out of (or transferring) the position is the "executing party" with the trade reporting obligation and the firm stepping into (or receiving) the position is the contra party.[13]

The "step-in" indicator is only used when both sides are submitting a non-tape/clearing-only report to the FINRA Facility. The "step-in" indicator should not be used on single step-out submissions that are "locked in" pursuant to an Automatic Give-Up (AGU) or Qualified Special Representative (QSR) agreement between the parties.[14]

Conclusion

FINRA encourages firms to review their trading practices and policies and procedures, including written supervisory procedures, to ensure that their step-out submissions comply with applicable trade reporting requirements and guidance.

Endnotes

1. For purposes of this *Notice*, the "FINRA Facilities" are the Alternative Display Facility (ADF), a Trade Reporting Facility (TRF) and the OTC Reporting Facility (ORF).

2. *See, e.g., Trade Reporting Frequently Asked Questions (FAQ),* Section 301 (Reporting Step-Outs).

3. *See, e.g., Trade Reporting FAQ*, Section 302 (Reporting Riskless Principal Transactions) and Section 303 (Reporting Agency Transactions).

4. FINRA notes that if Firm 1's capacity is marked as principal in the tape report, Firm 1 would be required to submit a non-tape report for the offsetting leg to reflect Firm 1's capacity as riskless principal. *See, e.g., Trade Reporting FAQ,* Section 302 (Reporting Riskless Principal Transactions).

5. Rules 7130(g), 7230A(i), 7230B(h) and 7330(h) expressly prohibit firms from submitting to a FINRA Facility any non-tape report (including but not limited to reports of step-outs) associated with a previously executed trade that was not reported to that FINRA Facility.

6. FINRA notes that the FINRA/Nasdaq TRF Carteret and the FINRA/Nasdaq TRF Chicago are separate and distinct facilities. As such, firms are prohibited from submitting a step-out to one FINRA/Nasdaq TRF relating to a trade that was reported for tape purposes to the other FINRA/Nasdaq TRF. *See, e.g., Trade Reporting FAQ,* # 300.2.

7. *See, e.g., Trade Reporting FAQ*, Section 304 (Reporting Net Trades).

8. *See Trade Reporting FAQ*, # 301.7 and #s 101.11 – .12.

9. Pursuant to Section 31 of the Securities Exchange Act of 1934, FINRA and the national securities exchanges are required to pay transaction fees and assessments to the SEC that are designed to recover the costs related to the government's supervision and regulation of the securities markets and securities professionals. FINRA obtains its Section 31 fees and assessments from its membership in accordance with Section 3.

10. *See Trade Reporting FAQ,* #s 301.9 – 10.

11. Firms should refer to the *Trade Reporting FAQ* for guidance on transferring the Section 3 fee when stepping out of a tape-reported trade by the firm, as principal, with its customer (rather than a tape-reported trade by the firm with the street). *See Trade Reporting FAQ,* #s 301.14 – 15.

12. The FINRA/Nasdaq TRF, ADF and ORF offer acceptance functionality, where the reporting party submits the trade information and the contra party then accepts (or declines) the trade information submitted by the reporting party. These Facilities also offer matching functionality, where each party enters its own trade information, and the Facility matches the two reports. *See Trade Reporting FAQ,* # 103.1.

13. *See Trade Reporting FAQ*, # 301.12.

14. *See Trade Reporting FAQ*, # 301.13.