

Payments for Market Making

Retrospective Rule Review Report

Summary

In November 2017, FINRA launched a retrospective review of Rule 5250 (Payments for Market Making), which generally prohibits members from receiving payments for market making, to assess its effectiveness and efficiency.¹ The review is part of an ongoing initiative to periodically look back at a rule or set of rules to ensure they remain relevant and are appropriately designed to achieve their regulatory objectives, particularly in light of industry, market and technology changes.

Based on the assessment, which involved feedback from both internal stakeholders and a wide range of external stakeholders, FINRA has determined to maintain the rule without change. This *Notice* summarizes the review process, the predominant themes that emerged from stakeholder feedback and the basis for the determination.²

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Background & Discussion

Rule Requirements

Rule 5250 prohibits a member or associated person from accepting payment or other consideration, directly or indirectly, from an issuer or its affiliates and promoters, for publishing a quotation, acting as a market maker or submitting an application in connection therewith. The rule excepts: (1) payment for bona fide services, including, but not limited to, investment banking services (including underwriting compensation and fees); (2) reimbursement of any payment for registration imposed by the U.S. Securities and Exchange Commission (SEC) or state regulatory authorities, and for listing fees imposed by a self-regulatory organization; and (3) any payment expressly provided for under the rules of a national securities exchange that are effective after being

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Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Market Making
- ▶ Operations
- ▶ Senior Management
- ▶ Trading

Key Topics

- ▶ Form 211
- ▶ OTC Equity Securities
- ▶ Payments for Market Making

Referenced Rules & Notices

- ▶ FINRA Rule 5250
- ▶ FINRA Rule 6432
- ▶ Notice to Members 75-16
- ▶ Regulatory Notice 17-41
- ▶ SEC Regulation M
- ▶ Section 5 of the Securities Act
- ▶ Securities Exchange Act Rule 15c2-11 (SEA Rule 15c2-11)

filed with, or filed with and approved by, the SEC. The prohibition on accepting payments for market making is intended to assure that members act in an independent capacity when publishing a quotation or making a market in an issuer's securities.³ FINRA has stated that such payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.⁴

FINRA amended Rule 5250 in 2013 to adopt paragraph (a)(3), which provides an exception for any payment expressly provided for under the rules of a national securities exchange to accommodate exchange market maker incentive programs for exchange-traded products (ETPs).⁵ Under these programs, the exchanges could make payments to market makers that were funded through additional fees paid by participating issuers.⁶

Assessment

The retrospective review process has two phases: the assessment phase and the action phase. During the assessment, FINRA staff evaluates whether the rule is meeting its investor protection objectives by reasonably efficient means. The subsequent action phase effectuates any recommendations arising from the assessment, which could include, among others, changes to the rule or its administration. However, not every assessment results in rule changes—the assessment may conclude that the rule remains relevant and appropriately tailored to meet its objectives. To conduct this assessment, FINRA first sought feedback from all interested external stakeholders through a request for comment in [Regulatory Notice 17-41](#). FINRA received 21 comment letters from a cross-section of stakeholders.⁷ FINRA also conducted telephonic interviews with several stakeholders, and sought input from advisory committees comprising firms of different sizes and business models and investor protection advocates. In addition, FINRA obtained the perspective of its operating departments, most notably Market Regulation and the Office of Fraud Detection and Market Intelligence.

A couple of key themes emerged during the assessment. First, a number of external stakeholders commented on whether FINRA should permit ETP issuers to make direct payments to market makers for market making services. Second, a few external stakeholders recommended an exception to permit issuers to reimburse market makers for expenses incurred in connection with the filing of a Form 211.⁸ Several stakeholders also noted the continued importance of the protections provided by the rule for individual securities.

Allowing ETP Issuers to Make Direct Payments to Market Makers

Several stakeholders requested that FINRA provide an exception from Rule 5250 that would permit ETP issuers to pay market makers directly—outside of the context of an exchange-administered program. In general, these stakeholders believed that the derivative nature of ETPs and the associated arbitrage mechanism significantly mitigated the concerns regarding illusory market activity that the rule was designed to prevent. Several stakeholders also believed that an exception for ETPs could enhance liquidity for ETPs, among other potential benefits.

Other stakeholders, including FINRA's Investor Issues Committee, did not agree that an exception for ETPs was appropriate. Generally, these stakeholders believed that such an exception could result in a false impression of liquidity, carried the risk of unintended consequences, and ultimately could harm investors, including causing higher fees for fund shareholders. However, stakeholders generally did not oppose the existing exception under Rule 5250(a)(3) for any payment expressly provided for under the rules of a national securities exchange that are effective after being filed with, and approved by, the SEC.

FINRA considered the competing views expressed by stakeholders regarding a potential exception for ETPs outside of the context of an exchange program. In addition to considering the comments regarding the potential impact of an exception for ETPs, FINRA also notes that an exception permitting direct payments from issuers to market makers would present complex issues that require consideration under the federal securities laws, including Section 5 of the Securities Act of 1933⁹ and Rule 102 of SEC Regulation M,¹⁰ among others. On balance, FINRA believes that the rule continues to serve an important investor protection and market integrity purpose, including for ETPs, and believes that any payments for market making for specific products are best administered by a national securities exchange pursuant to its rules.

Individual Equity Securities

FINRA received comments requesting that Rule 5250 be amended to provide an exception for OTC equity securities to permit issuers to reimburse market makers for expenses incurred in connection with the filing of a Form 211. These commenters argued that the information gathering required by the Form 211 process cannot be performed without costs, and that allowing payment would result in higher quality and more useful information to investors.

FINRA considered these stakeholder views in light of the objectives of the rule's prohibition on the receipt of payments in connection with the Form 211 process. The current rule was designed to address concerns regarding influence over a member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote. FINRA previously considered and decided against permitting reimbursement of expenses incurred in connection with the filing of a Form 211, including due to concerns

that such payments could be used inappropriately to avoid the limitations of the rule.¹¹ FINRA believes that these concerns remain relevant today. Thus, FINRA does not believe that an exception for reimbursement of expenses in connection with the filing of a Form 211 is appropriate, and believes that the rule continues to serve an important purpose for OTC equity securities, including that it supports the integrity of the SEA Rule 15c2-11 information gathering process. As suggested by a stakeholder, FINRA is considering issuing additional guidance regarding the receipt of compensation from issuers in connection with the provision of certain advisory services under Rule 5250(b)(1).¹²

Conclusion

Rule 5250 is designed to assure that members act in an independent capacity when publishing a quotation or making a market in an issuer's securities. FINRA believes that the potential conflict of interest and market integrity concerns underlying Rule 5250 continue to exist, and that the rule continues to meet its regulatory objectives effectively and efficiently. Accordingly, FINRA has determined to maintain the rule in its current form. As noted above, FINRA will consider issuing additional guidance regarding the exception contained in Rule 5250(b)(1).

Endnotes

1. See [Regulatory Notice 17-41](#) (November 2017). In response to the *Notice*, FINRA received 21 comment letters from: Chris Concannon, Cboe Global Markets, Inc. (November 22, 2017); Douglas A. Cifu, Virtu Financial Inc. (January 3, 2018); Mike Rask and James Toes, Security Traders Association (January 22, 2018); Richard Keary, John Jacobs, Justin Meise, and Bibb L. Strench, ETF BILD (January 26, 2018); Ryan Ludt, Vanguard (January 29, 2018); Samara Cohen, Joanne Medero, and Deepa Damre, BlackRock (January 29, 2018); Franklin Gold, FG Consulting & Advising, LLC (January 29, 2018); Andrew Stevens, IMC Financial Markets (January 29, 2018); Reginald M. Browne, Cantor Fitzgerald & Co. (January 29, 2018); Theodore R. Lazo, Securities Industry and Financial Markets Association (January 29, 2018); Anna Paglia, Invesco PowerShares Capital Management LLC (January 29, 2018); Timothy J. Coyne, State Street Global Advisors (February 1, 2018); Thomas E. Faust Jr., Eaton Vance Corp. (February 2, 2018); S. Phillip Bak, Exponential ETFs (February 7, 2018); Daniel Zinn, OTC Markets Group Inc. (February 8, 2018); C. Dirk Peterson, K&L Gates (February 16, 2018); Robert L. Sonfield, Jr., Sonfield & Sonfield (March 5, 2018); Damon Walvoord and G. Bart Smith, Susquehanna International Group, LLC (March 16, 2018); Eric Flesche, Glendale Securities, Inc. (April 3, 2018); Douglas A. Cifu, Virtu Financial Inc. (June 7, 2018); and Anita Rausch and Ryan Louvar, WisdomTree Asset Management, Inc. (June 8, 2018).
2. The term “stakeholder” is used to describe those entities, organizations and persons who may be impacted by or otherwise have an interest in Rule 5250. For example, FINRA conferred with the Investor Issues Committee, Large Firm Advisory Committee, Small Firm Advisory Committee, Membership Committee and Market Regulation Committee at their respective meetings, and conducted telephonic interviews with several additional stakeholders.
3. See Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (Order Approving File No. SR-NASD-97-29) and *Notice to Members 75-16* (February 1975).
4. *Id.*
5. See Securities Exchange Act Release No. 69398 (April 18, 2013), 78 FR 24261 (April 24, 2013) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2013-020).
6. See *e.g.* Securities Exchange Act Release No. 69706 (June 6, 2013), 78 FR 35340 (June 12, 2013) (Order Granting Approval of File No. SR-NYSEArca-2013-34 as Modified by Amendment Nos. 1 and 2 Thereto) (“NYSE Arca Approval Order”); Securities Exchange Act Release No. 71804 (March 26, 2014), 79 FR 18357 (April 1, 2014) (Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of File No. SR-NYSEArca-2013-141 as Modified by Amendment No. 2); and Securities Exchange Act Release No. 72692 (July 28, 2014), 79 FR 44908 (Order Granting Approval of File No. SR-BATS-2014-022).
7. See *supra* note 1.
8. FINRA Rule 6432 (Compliance with the Information Requirements of SEA Rule 15c2-11) provides that a firm must file a Form 211 with FINRA to demonstrate compliance with SEA Rule 15c2-11. See FINRA Rule 6432 and 17 CFR 240.15c2-11.

9. For example, in the orders approving the exchange incentive programs, the SEC cited to a 1981 SEC Release that discussed factors that may deem a market maker to be a statutory underwriter, including the existence of “special arrangements” with, or receipt of “special compensation” from, the issuer. *See e.g.*, Securities Exchange Act Release No. 69706 (June 6, 2013) 78 FR 35340 (June 12, 2013) (Order Granting Approval of File No. SR-NYSEArca-2013-34 as Modified by Amendment Nos. 1 and 2 Thereto); *see also* Securities Act Release No. 6334 (August 6, 1981), 46 FR 42001 (August 18, 1981), at Section IV.B (Treatment as Statutory Underwriter).
10. For example, SEC approval of the exchanges’ ETP programs were accompanied by relief under SEC rules, including Rule 102 of SEC Regulation M. *See* 17 CFR 242.102 (Rule 102 of Regulation M addresses activities by issuers and selling security holders during a distribution). *See also* Securities Exchange Act Release No. 69707 (June 6, 2013), 78 FR 35330 (June 12, 2013) (Order Granting a Limited Exemption from Rule 102 of Regulation M Concerning the NYSE Arca, Inc.’s Exchange Traded Product Incentive Program Pilot Pursuant to Regulation M Rule 102(e)).
11. *See* Securities Exchange Act Release No. 38670 (May 22, 1997), 62 FR 29382 (May 30, 1997) (Notice of Filing of File No. SR-NASD-97-29).
12. *See* Rule 5250(b)(1). Rule 5250 does not prohibit a member from receiving payment for bona fide services that are not market making, and FINRA previously has provided written interpretive guidance regarding certain advisory arrangements. Such guidance generally provides that services rendered may fall within the bona fide services exception of the rule, but that the conclusion will depend upon the specific payments made and services that ultimately are rendered.