

OTC Trade Reporting

FINRA Requests Comment on Proposed Amendments to OTC Trade Reporting Requirements for Equity Securities

Comment Period Expires November 12, 2007

Executive Summary

FINRA is issuing this *Notice* to solicit comments from member firms and other interested parties on two proposals relating to OTC trade reporting requirements applicable to listed and unlisted equity securities.

- **Trade Reporting Structure Proposal.** FINRA is proposing to simplify and update the current market maker-based trade reporting structure and is seeking comment on alternative structures, such as, *e.g.*, requiring the sell-side or executing party to report a trade in all cases, except where a trade is with a customer or non-member firm.
- **Linking Proposal.** FINRA is proposing to require firms to provide information sufficient to link tape and non-tape reports that are submitted to FINRA for the same overall transaction (*e.g.*, riskless principal or agency where a firm is acting as agent on behalf of another member firm).

These proposals are discussed in greater detail on the following pages.

September 2007

Notice Type

- Request for Comment

Suggested Routing

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

Key Topic(s)

- Agency
- Alternative Display Facility
- OTC Reporting Facility
- Riskless Principal
- Trade Reporting
- Trade Reporting Facilities

Referenced Rules & Notices

- NASD Rules 4632, 4632A, 4632C and 4632E
- NASD Rule 6620
- Regulatory Notice 07-38

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by November 12, 2007. Member firms and other interested parties can submit their comments using the following methods:

- ▶ Mailing comments in hard copy to the address below; or
- ▶ Emailing comments to pubcom@finra.org.

To help FINRA process and review comments more efficiently, you should only use one method to comment on this proposal; however, if you wish to submit comments using more than one of the methods listed above, you should indicate that in the submissions.

Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Important Notes: The only comments that will be considered 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 Web site. Generally, comments will be posted on the FINRA Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation at (240) 386-5126; or the Office of General Counsel at (202) 728-8071.

Background & Discussion

FINRA is soliciting comment on two proposals to amend over-the-counter (OTC) trade reporting requirements for equity securities transactions. For purposes of this *Notice*, the term “OTC trade reporting requirements” refers to the trade reporting rules relating to:

- (1) trades in NMS stocks, as defined in SEC Rule 600(b)(47) of Regulation NMS, effected otherwise than on an exchange that are reported to FINRA through the Alternative Display Facility (ADF) or a Trade Reporting Facility (TRF); and
- (2) trades in non-exchange-listed securities (*e.g.*, OTCBB and Pink Sheet securities) that are reported to FINRA through the OTC Reporting Facility (ORF).

Trade Reporting Structure Proposal

Under current rules, the following trade reporting structure is in place: (1) in transactions between two market makers, the sell-side reports; (2) in transactions between a market maker and a non-market maker, the market maker reports; (3) in transactions between two non-market makers, the sell-side reports; and (4) in transactions between a member firm and either a non-member or customer, the member firm reports.³

FINRA understands that this reporting structure can result in confusion, delays and double-reporting, as the parties to a trade attempt to determine which party has the trade reporting obligation. Today, a firm’s status as a market maker may not always be apparent to the contra-party to a trade and, increasingly, firms’ proprietary desks (other than their market making desks) are handling and executing transactions in equity securities.

FINRA is soliciting comment on a proposal to create a simpler, more uniform trade reporting structure. FINRA’s goal is to adopt an approach that will result in more accurate and timely trade reporting and make the trade reporting process less cumbersome for firms.

One approach FINRA is considering is a sell-side reporting structure, whereby the sell-side to a transaction between member firms would always have the trade reporting obligation. In trades between a member firm and a customer (the term “customer” does not include a broker-dealer) or between a member firm and a non-member, the member firm would report the trade.

A second approach FINRA is considering is an executing broker reporting structure, whereby the broker executing a trade between member firms would always have the trade reporting obligation. In trades between a member firm and a non-member or customer, the member firm would report the trade. Proponents of an executing broker reporting structure contend that such an approach better aligns the trade reporting responsibility with the party responsible for compliance with SEC Rule 611 of Regulation NMS (the Order Protection Rule). By aligning these requirements, the firm with the trade reporting obligation will also be the party that is aware of and can properly report whether an exception or exemption from the Order Protection Rule applied to the transaction.

FINRA is soliciting comments on the following issues:

- What are the advantages and disadvantages (if any) of the current reporting structure and the two structures described above?
- Is there another reporting structure or variation on the two structures described above that should be considered?
- With respect to the proposed executing broker reporting structure, how would firms define “executing broker”? Are there any instances where it may be difficult to identify the executing broker to a transaction? For example, where two member firms agree to a trade over the telephone or where a member firm electronically delivers an order against another member firm’s quote, which member firm is considered the executing broker? If there are situations in which the executing broker is not easily determined or the two parties disagree as to which party has the reporting obligation, how would firms propose handling trade reporting in such instances?
- What are the technological implications and burdens associated with each of the reporting structures described above?
- How much time would firms need to make the necessary systems changes to implement each of the reporting structures described above?

Linking Proposal

Under the existing trade reporting rules, firms are not required to input a unique identifier that allows FINRA to easily link multiple trade report submissions related to the same overall transaction.⁴ Thus, for example, if a tape report (*i.e.*, the transaction is reported to the tape for publication) and a non-tape report (*i.e.*, a report for purposes other than for tape publication and generally for clearing or regulatory purposes) are submitted to FINRA for a riskless principal transaction,⁵ there currently is no specific information on either report to indicate that it relates to another trade report that has also been submitted. Similarly, if a firm is acting in an agency capacity on behalf of another member firm in an OTC trade and submits a non-tape report to FINRA to reflect the offsetting portion of the agency trade,⁶ there is no specific information to link the related tape and non-tape reports for this transaction.

FINRA is soliciting comment on a proposal to require that firms provide information to link related reports when both a tape and non-tape report are submitted to FINRA for the same overall transaction.⁷ FINRA is considering as a possible approach requiring firms to include the same unique identifier on both the tape and non-tape report. Such linking information would allow FINRA staff to recreate more accurately a firm's market activity. Additionally, it would enable FINRA staff to validate that there is, in fact, a tape report associated with a non-tape report and ensure that firms are not using non-tape transactions to circumvent other rules (*e.g.*, the Limit and Market Order Protection Rules).⁸

Specifically, FINRA is soliciting comments on the following issues:

- If FINRA mandated the use of a unique identifier on trade reports so that tape and non-tape reports could be linked, should the identifier be:
 - (1) a unique identifier that is generated and submitted by the firm (*e.g.*, as a new field on both the tape and non-tape reports) (Option 1); or
 - (2) a control number assigned by the trade reporting facility on the confirmation of receipt of the tape report that would then be entered by the firm submitting the non-tape report (Option 2)?
- What are the advantages and disadvantages (if any) of each of the options described above?
- Is there another linkage mechanism that firms believe should be considered?
- With respect to Option 1, would a firm that is not the reporting party on the tape report be in a position to ensure that a unique identifier is generated and submitted by the reporting party in that tape report? If this is problematic in certain situations, should the firm submitting the non-tape report be required to use the control number set forth in Option 2?
- Should submission of linkage information be required on a "real-time" basis at the time the trade report is submitted, or is there an alternative that would facilitate linking of reports through end-of-day submissions?
- How would situations where multiple tape reports need to be linked to a single non-tape report, or vice versa, be addressed under any approach? If firms were to generate the unique identifier under Option 1, FINRA believes this may facilitate use of that same unique identifier on multiple related reports. If firms were required to use a control number assigned by a trade reporting facility under Option 2, each tape report would be assigned a different control number. Would firms be able to input multiple assigned control numbers into a single report?

- ▶ If linking multiple reports to a single report is problematic, FINRA also is considering whether mandating a one-to-one ratio, such that a single non-tape report must be submitted for each tape report (*i.e.*, aggregation of reports for linkage purposes would not be permitted), is appropriate. What problems or issues, technological or otherwise, would that raise?
- ▶ Rather than require that linkage information be provided, would the use of three-party trade reports, which would embed linkage information within a single three-party trade report submission, provide a more workable option?⁹ Could such an approach be under- or over-inclusive?
- ▶ How should FINRA handle non-tape reports that need to be linked to reports of trades executed on and reported to the tape through an exchange?¹⁰
- ▶ In addition to riskless principal transactions and agency transactions where a firm acts as agent on behalf of another member firm, there are other types of transactions that require the submission of related tape reports and non-tape reports (*e.g.*, cross transactions by Alternative Trading Systems involving multiple member firms and step-outs and reversals of previously executed trades). Are there any specific issues or problems with extending the proposed linking requirement to these and any other types of related transactions? Are there other types of transactions for which firms submit related tape and non-tape reports?
- ▶ What are the technological implications and burdens associated with FINRA's proposal to require firms to link tape and non-tape reports submitted to FINRA?
- ▶ How much time would firms need to make the necessary systems changes to implement this proposal?

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 See NASD Rules 4632(b) (relating to the FINRA/NASDAQ TRF); 4632A(b) (relating to the ADF); 4632C(b) (relating to the FINRA/NSX TRF); 4632E(b) (relating to the FINRA/NYSE TRF); 6620(b) (relating to the ORF).
- 4 FINRA recently filed with the SEC a proposed rule change to require that on any non-tape (or clearing-only) report submitted to a FINRA facility associated with a previously executed trade that was not reported to that same FINRA facility, firms identify the facility or market where the associated trade was reported. See SR-FINRA-2007-012, available at www.finra.org/RulesRegulation/RuleFilings/2007RuleFilings/P036903. Thus, for example, if the initial leg of a riskless principal (or agency) transaction is an over-the-counter trade reported to the FINRA/NYSE TRF, a firm submitting a non-tape (or clearing-only) report for the offsetting leg to the FINRA/NASDAQ TRF would be required to use a special indicator on that report to designate that the initial leg was reported to the FINRA/NYSE TRF. However, there would be no information to directly link the non-tape report submitted to the FINRA/NASDAQ TRF to the tape report submitted to the FINRA/NYSE TRF for this transaction.
- 5 For purposes of OTC trade reporting requirements, a “riskless principal” transaction is a transaction in which a firm, after having received an order to buy (sell) a security, purchases (sells) the security as principal (the initial leg) and satisfies the original order by selling (buying) as principal at the same price (the offsetting “riskless” leg). Firms may report a riskless principal transaction in one of two ways. One alternative is to report the transaction in a single tape report that is marked with a “riskless principal” capacity indicator. The other alternative is to submit two (or more, as necessary) reports: a tape report to reflect the initial leg of the transaction and a non-tape report that is marked as riskless principal to reflect the offsetting “riskless” leg. See NASD Rules 4632(d)(3)(B) (relating to the FINRA/NASDAQ TRF); 4632A(e)(1)(C)(ii) (relating to the ADF); 4632C(d)(3)(B) (relating to the FINRA/NSX TRF); 4632E(e)(3)(B) (relating to the FINRA/NYSE TRF); 6620(d)(3)(B) (relating to the ORF).
- 6 See *FINRA Regulatory Notice 07-38* (August 2007).
- 7 At this time, FINRA is not proposing to require that firms provide specific linking information for trades executed on and reported through exchanges, but is soliciting comment on this concept generally, as indicated below.
- 8 The New York Stock Exchange and the Boston Stock Exchange have addressed issues associated with linking trade reports for multiple legs of a riskless principal transaction. See Securities Exchange Act Release No. 56017 (July 5, 2007), 72 FR 38110 (July 12, 2007) (order approving SR-NYSE-2007-21); Securities Exchange Act Release No. 51251 (February 24, 2005), 70 FR 10439 (March 3, 2005) (order approving SR-BSE-2004-27).

Endnotes

- 9 A three party trade report is a single last sale trade report that denotes one reporting member and two contra parties. *See, e.g.*, NASD Rule 4632A(d).
- 10 Pursuant to proposed rule change SR-FINRA-2007-012 (*see note 4*), if, for example, the initial leg of a riskless principal (or agency) transaction is executed on and reported through the NASDAQ Exchange, a firm submitting a non-tape (or clearing-only) report for the offsetting leg of the transaction to FINRA would be required to use a special indicator on that report to designate that the initial leg was reported through the NASDAQ Exchange. However, there would be no information to directly link the non-tape report to the related tape report.