

REG NMS-Principled Rules

SEC Approves Amendments to Establish Regulation NMS-Principled Rules in Market for OTC Equity Securities

Effective Dates: FINRA Rules 6434, 6437 and 6450: February 11, 2011; FINRA Rule 6460 and NASD Rule 2320: May 9, 2011

Executive Summary

Effective February 11, 2011, and May 9, 2011, are new FINRA rules that extend certain Regulation NMS protections to quoting and trading of over-the-counter (OTC) Equity Securities.¹ For OTC Equity Securities, these new rules:

- set forth the permissible pricing increments for the display of quotations and acceptance of orders;
- require firms to avoid locking and crossing quotations within an inter-dealer quotation system;
- establish a cap on access fees imposed against a firm's published quotation; and
- require an OTC Market Maker, subject to certain exceptions, to display the full size of customer limit orders that improve the price of the market maker's displayed quotation or that represent more than a *de minimis* change in the size of the market maker's quote if at the best bid or offer (BBO).

The text of the amendments can be found in the FINRA Manual at www.finra.org/finramanual.

Questions regarding this *Notice* should be directed to Racquel Russell, Assistant General Counsel, Office of General Counsel, at (202) 728-8363.

September 2010

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Technology
- Trading and Market Making

Key Topic(s)

- Access Fees
- Limit Order Display
- Locking and Crossing Quotations
- Minimum Pricing Increment
- OTC Equity Securities
- Quotations

Referenced Rules & Notices

- FINRA Rule 6240
- FINRA Rule 6434
- FINRA Rule 6437
- FINRA Rule 6450
- FINRA Rule 6460
- FINRA Rule 6540
- NASD Rule 2320
- SEA Regulation NMS

Background and Discussion

FINRA is implementing new rules to extend certain SEC Regulation NMS protections to quoting and trading in OTC Equity Securities² (NMS-Principled Rules). The NMS-Principled Rules include rules:

- defining quotation pricing increments;
- prohibiting locked and crossed quotations;
- implementing a cap on access fees; and
- requiring the display of customer limit orders by OTC Market Makers.³

FINRA believes that applying these Regulation NMS principles to OTC Equity Securities will enhance market quality and investor protection in this market.

The rules addressing minimum pricing increments for OTC Equity Securities (Rule 6434), prohibiting locked and crossed quotations in OTC Equity Securities (Rule 6437) and restricting access fees imposed against a firm's published quotation in OTC Equity Securities (Rule 6450) will become effective on February 11, 2011. The rule requiring the display of customer limit orders in OTC Equity Securities (Rule 6460) will become effective on May 9, 2011.

Restrictions on Sub-penny Quoting

FINRA Rule 6434 provides that, for OTC Equity Securities priced equal to or greater than \$1.00 per share, no firm shall display, rank or accept a bid or offer, an order or an indication of interest in any OTC Equity Security that is priced in an increment smaller than \$0.01. For OTC Equity Securities priced less than \$1.00 per share, Rule 6434 prohibits firms from displaying, ranking or accepting a bid or offer, an order or an indication of interest priced in an increment smaller than \$0.0001. However, in recognition of the smaller price points of OTC Equity Securities, where an order or indication of interest itself is priced less than \$0.0001, a firm may rank or accept (but not display) such order or indication of interest in an increment of \$0.000001 or greater.

Locked and Crossed Markets

FINRA Rule 6437 requires firms to implement policies and procedures to reasonably avoid displaying, or engaging in a pattern or practice of displaying, locking or crossing quotations in any OTC Equity Security.

The rule defines a "crossing quotation" as "the display of a bid for an OTC Equity Security at a price that is higher than the displayed price of an offer for such OTC Equity Security in the same inter-dealer quotation system, or the display of an offer for an OTC Equity Security at a price that is lower than the displayed price of a bid for such OTC Equity Security in the same inter-dealer quotation system."⁴

The term “locking quotation” is defined as “the display of a bid for an OTC Equity Security at a price that equals the displayed price of an offer for such OTC Equity Security in the same inter-dealer quotation system, or the display of an offer for an OTC Equity Security at a price that equals the displayed price of a bid for such OTC Equity Security in the same inter-dealer quotation system.”⁵

Access Fee Cap

FINRA Rule 6450 provides that a firm may not impose, nor permit to be imposed, non-subscriber access or post-transaction fees against its published quotation in any OTC Equity Security that exceed or accumulate to more than certain specified limits. Specifically, if a published quotation is priced equal to or greater than \$1.00, the access fee cap is \$0.003 per share, which is the same cap under SEC Regulation NMS. However, with respect to published quotations priced under \$1.00, the access fee cap for OTC Equity Securities is the lesser of: (i) 0.3% of the published quotation price on a per share basis, or (ii) 30% of the minimum pricing increment under Rule 6434 relevant to the display of the quotation on a per-share basis.

Consistent with Regulation NMS’s framework, FINRA’s new NMS-Principled Rules also make clear that market makers, as well as alternative trading systems (ATSs), are permitted to charge access fees within the parameters of the access fee cap. In addition, FINRA Rule 6540(c) previously required that an ATS or electronic communication network (ECN) reflect non-subscriber access or post-transaction fees in the ATS’s or ECN’s posted quote in the OTC Bulletin Board montage—but this requirement is being eliminated.

Limit Order Display

FINRA Rule 6460 requires OTC Market Makers displaying a priced quotation in any OTC Equity Security in an inter-dealer quotation system to immediately⁶ publish a bid or offer that reflects:

- the price and the full size of each customer limit order held by the OTC Market Maker that is at a price that would improve the bid or offer of such OTC Market Maker in such security; and
- the full size of each customer limit order held by the OTC Market Maker that:
 - is priced equal to the bid or offer of such OTC Market Maker for such security;
 - is priced equal to the BBO of the inter-dealer quotation system in which the OTC Market Maker is quoting; and
 - represents more than a *de minimis* change⁷ in relation to the size associated with the OTC Market Maker’s bid or offer.

Rule 6460 also includes parallel exceptions currently in place in Regulation NMS's limit order display rule (Rule 604 of SEC Regulation NMS). Thus, the new rule excepts any customer limit order that is:

- executed upon receipt of the order;
- placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed;
- an odd-lot order;
- a block size order, unless a customer placing such order requests that the order be displayed;
- delivered immediately upon receipt to a national securities exchange or an ECN that widely disseminates such order and that complies with enumerated requirements with respect to that order;⁸
- delivered immediately upon receipt to another OTC Market Maker that complies with the requirements of this rule with respect to that order; or
- an all-or-none order.

Because FINRA Rule 6434 provides that firms may rank and accept (but not display) orders and indications of interest in an increment of \$0.000001 or greater where an order or indication of interest itself is priced less than \$0.0001, the limit order display rule likewise exempts from the display requirement any customer limit order that is priced less than \$0.0001 per share.

Frequently Asked Questions

Question 1: FINRA Rule 6460 contains a *de minimis* standard applicable in situations where a customer limit order equals an OTC Market Maker's displayed price and that price is equal to the BBO. Will FINRA use the SEC's Regulation NMS Rule 604 interpretation of *de minimis* of 10 percent or less?

Response: *Yes. In connection with all of FINRA's NMS-Principled Rules, FINRA generally intends to adopt the same interpretive positions taken by the SEC in connection with the comparable provisions of Regulation NMS, unless explicitly noted otherwise. Thus, the size of a customer limit order is considered de minimis for purposes of Rule 6460 if it is less than or equal to 10 percent of the displayed size associated with an OTC Market Maker's bid or offer.*

Question 2: Must firms aggregate multiple, same-priced customer limit orders to determine whether the *de minimis* standard has been exceeded?

Response: *Yes. As is required by the SEC in connection with Regulation NMS's limit order display rule, firms must aggregate same-priced customer limit orders in OTC Equity Securities at the BBO in order to determine if the de minimis standard has been exceeded and the currently displayed quotation size updated.⁹ The SEC specifically stated that all orders previously considered de minimis and not displayed must be added to the order under consideration for purposes of the de minimis calculation.¹⁰ The same requirement shall apply under FINRA Rule 6460.*

Question 3: Rule 6460 generally requires OTC Market Makers to display the full size of any customer limit order that improves the price of the firm's quote if at the BBO. If the size of the customer limit order is less than the tier size requirements of Rule 6450 (Minimum Quotation Size Requirements for OTC Equity Securities), is the firm required to display the limit order?

Response: *No. If a firm receives a customer limit order in an OTC Equity Security at a price that improves such firm's displayed quotation, but for a size that is less than the tier size requirements of Rule 6450, the firm is not required to display the price and full size of such customer limit order.*

For example, if an OTC Market Maker's quote is \$9.98 – \$10.00 (500x500) and the market maker receives a customer limit order to buy 200 shares at \$9.99, the market maker is not required to display the customer limit order because it is less than the minimum tier-size requirement for securities priced between \$1.01 and \$10.00 (500 shares) under Rule 6450. However, if the market maker receives additional customer limit orders to buy at \$9.99 that, together, equal 500 shares or greater, the market maker would be required to change its quotation to \$9.99 - \$10.00 and to reflect the aggregate size of such orders.

Question 4: Rule 6460 generally requires OTC Market Makers to publish "immediately" customer limit orders. What is FINRA's definition of "immediately?"

Response: *As stated above, FINRA generally intends to adopt those interpretative positions taken by the SEC in connection with comparable requirements under Regulation NMS. The SEC has stated that, unless relying on one of the exceptions to the limit order display rule, specialists or OTC Market Makers must display customer limit orders as soon as is practicable after receipt which, under normal market conditions, would require display no later than 30 seconds after receipt.¹¹*

Question 5: Under Regulation NMS, a “block size” with respect to an order means it is: (A) of at least 10,000 shares or (B) for a quantity of stock having a market value of at least \$200,000. Does this same definition apply to Rule 6460?

Response: *No. Rule 6460(d)(2) provides that “block size” with respect to an order means it is of at least 10,000 shares and has a market value of at least \$100,000, which also is consistent with the large order size exception under NASD IM-2110-2 (Trading Ahead of Customer Limit Order). As discussed in the Proposing Release,¹² because of the lower average trade prices (and corresponding higher average total share amount) of orders in OTC Equity Securities, FINRA believes that a 10,000 share standard alone would potentially exclude customer limit orders that should be displayed.*

Question 6: Rule 6460 provides an exception from the limit order display requirement for orders where the customer “expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer’s orders, that the order not be displayed.” What type of documentation does FINRA expect firms to maintain in connection with such customer requests?

Response: *As similarly stated by the SEC in connection with Regulation NMS’s limit order display rule, FINRA expects firms to discharge their responsibilities in such a manner as to allow adequate supervision of compliance with the customer’s request not to display the full size of a limit order or to display pursuant to discretionary authority provided by the customer, and does not believe it necessary to mandate a particular method of recordkeeping.¹³ In addition, as stated in other contexts, FINRA believes that firms relying on this or any other exception should be able to proffer evidence of its eligibility for and compliance with the exception.*

However, FINRA notes that standardized disclaimers or contractual language in new account agreements would not be deemed an individual request by a customer that its order or orders not be displayed.¹⁴ In contrast, adequate evidence of a customer’s request that a firm not display a limit order may, for example, include an affirmative letter from (or contract with) the customer specifically providing that the firm refrain from displaying the full size of a single order or a class of orders, or a notation entered on an order ticket or in the firm’s order-management system made contemporaneously at the time of order receipt.

Question 7: Must ECNs displaying a quotation on an inter-dealer quotation service comply with the limit order display rule?

Response: *No. FINRA Rule 6460 applies only to OTC Market Makers. However, we note that an exception exists for OTC Market Makers that deliver immediately a customer limit order to a national securities exchange or an ECN that widely disseminates such order and that complies with certain other requirements. Such requirements prescribe, among other things, that the ECN must provide to an inter-dealer quotation system the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in, and widely disseminated by, the ECN.¹⁵*

Question 8: Rule 6437 requires a firm to implement policies and procedures that reasonably avoid displaying, or engaging in a pattern or practice of displaying, locking or crossing quotations in any OTC Equity Security. What is a firm's obligation if it is unable to access another firm's quote?

Response: *FINRA recognizes that a firm's quotation may, on occasion, inadvertently lock or cross another firm's quotation. Thus, similar to Rule 6240 (Prohibition from Locking or Crossing Quotations in NMS Stocks), FINRA expects firms' policies and procedures to require the quoting participant to make "reasonable efforts" to first contact or route an order to execute against the full displayed size of any quotation before locking and crossing that quotation.*

For example, a firm may also include so-called "ship and post" procedures that require that it attempt to execute against a relevant displayed quotation while posting a quotation that could lock or cross such a quotation. In addition, firms' policies and procedures must be reasonably designed to enable the reconciliation of locked or crossed quotations, including requiring the firm to take reasonable action to resolve the locked or crossed market when such firm is responsible for displaying the locking or crossing quotation. If a firm has made reasonable attempts to access another firm's already-existing quotation but is unable to do so, such firm may then display its quotation, even if it would lock or cross the quotation of the other firm.

Question 9: If a firm is holding a customer order that must be re-priced because of a corporate action (e.g., a stock dividend, split or reverse split), may the firm round the adjusted price to a permissible increment?

Response: *Yes. As similarly stated by SEC staff in connection with Regulation NMS's minimum pricing increment rule, FINRA Rule 6434 does not require a firm to cancel an order that was permissible when accepted, but for which the price must be adjusted due to a corporate action.¹⁶ However, the firm would violate the rule by displaying or ranking the re-priced order at an increment not permitted by the rule.*

The same principle applies to other types of orders that were permissible when accepted, but whose prices must be adjusted; e.g., an order accepted before the rule's effective date may be re-priced to conform to the requirements of the rule without canceling the order. Firms always must round down in the case of an order to buy, and up in the case of an order to sell.

Question 10: If a firm receives a customer limit order priced in an increment that may be accepted but not displayed pursuant to Rule 6434, must the firm provide order protection to such un-displayed customer order?

Response: *Yes. While firms would not be required to display customer limit orders priced in an increment less than \$0.0001 (pursuant to Rule 6460), a firm's order protection obligations under IM-2110-2 (Trading Ahead of Customer Limit Order) would continue to apply.¹⁷*

Endnotes

- 1 See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010) (Order Approving File No. SR-FINRA-2009-054). In this order, the SEC also approved proposed changes to FINRA Rules 6430, 6431, 6432, 6433, 6435, 6440, and 6540. The changes to FINRA Rules 6430, 6431, 6432, 6433, 6435, 6440, and 6540 will become effective on February 11, 2011.
- 2 "OTC Equity Security" means any equity security that is not an "NMS stock" as that term is defined in Rule 600(b)(47) of Regulation NMS; provided, however, that the term OTC Equity Security shall not include any Restricted Equity Security. See FINRA Rule 6420(c). Rule 600(b)(47) of Regulation NMS defines "NMS stock" as "any NMS security other than an option." NMS security means "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." See Rule 600(b)(47) of Regulation NMS.
- 3 "OTC Market Maker" refers to a FINRA firm that holds itself out as a market maker by entering proprietary quotations or indications of interest for a particular OTC Equity Security in any inter-dealer quotation system, including any system that the SEC has qualified pursuant to Section 17B of the Exchange Act. A firm 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.
- 4 See Rule 6437(b)(1).
- 5 See Rule 6437(b)(2).
- 6 See Frequently Asked Question # 4 above for a discussion of FINRA's expectations with regard to the timing of display of customer limit orders.
- 7 See Frequently Asked Question # 1 above for a discussion of the meaning of "*de minimis*."
- 8 The ECN must (1) provide to a national securities exchange, national securities association or inter-dealer quotation system the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in, and widely disseminated by, the ECN; and (2) provide, to any broker or dealer, the ability to effect a transaction with a priced order widely disseminated by the ECN entered therein by an OTC market maker that is: (A) equivalent to the ability of any broker or dealer to effect a transaction with an OTC market maker pursuant to the rules of the applicable national securities exchange, national securities association or inter-dealer quotation system to which the ECN supplies such bids and offers; and (B) at the price of the highest priced buy order or lowest priced sell order, or better, for the lesser of the cumulative size of such priced orders entered therein by OTC market makers at such price, or the size of the execution sought by the broker or dealer, for such security.
- 9 See Securities Exchange Act Release No. 37619A (September 6, 1996); 61 FR 48290 (September 12, 1996) ("SEC Display Rule Adopting Release").
- 10 *Id.* at note 179.

Continued on next page.

Endnotes continued

- 11 See SEC Display Rule Adopting Release. Also, as stated in *Notice to Members 99-99* in connection with the SEC's limit order display requirements, FINRA notes that any systematic delay in the display of customer limit orders, regardless of how long, would constitute a violation of FINRA's limit order display rule. However, there is no "bright line, absolute" standard governing the number of seconds an OTC Market Maker has to complete its choice of displaying, executing, or routing a customer limit order. In addition, a firm may operate an automated system that defaults to display customer limit orders within 30 seconds of receipt, so long as the firm makes every effort to display the limit orders as soon as possible manually or otherwise.
- 12 See Securities Exchange Act Release No. 60515 (August 17, 2009), 74 FR 43207 (August 26, 2009) ("Proposing Release").
- 13 See SEC Display Rule Adopting Release at note 186.
- 14 See also SEC Display Rule Adopting Release at 48304.
- 15 See Rule 6460(c)(1).
- 16 Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 612 (Minimum Pricing Increment) of Regulation NMS at Question #3.
- 17 For customer limit orders priced less than \$.00001, the minimum amount of price improvement required is the lesser of \$0.000001 or one-half (1/2) of the current inside spread. See NASD IM-2110-2(a).