

December 23, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2011-058 — Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing, a proposed rule change to amend FINRA Rule 6433 (Minimum Quotation Size Requirements for OTC Equity Securities) to modify the minimum number of shares applicable to over-the-counter quotations displayed on an inter-dealer quotation system.¹

As discussed in the filing, this proposed rule change is being put forth at this time because of an important investor protection rule that went into effect earlier this year in the over-the-counter (“OTC”) market: the Limit Order Display Rule.² FINRA’s Limit Order Display Rule extends a fundamental protection to investors in OTC equity securities that has existed for some time for investors in exchange-listed companies. The Limit Order Display Rule generally requires market makers to display to the market their customers’ competitively priced limit orders. Through the extension of this Limit Order Display requirement for OTC equity securities, investors may now benefit from enhanced transparency of limit orders, improved prices and increased execution opportunities.³ However, those benefits are reduced if the minimum quotation sizes are too high and act to restrict transparency of a large number of customer limit orders.

¹ See Securities Exchange Act Release No. 65568 (October 14, 2011), 76 FR 65307 (October 20, 2011) (“Notice of Filing of SR-FINRA-2011-058”).

² FINRA Rule 6460 (Display of Customer Limit Orders) (the “Limit Order Display Rule”).

³ As previously stated by the SEC, customer limit order display is beneficial to the markets:

The financial markets as a whole should benefit from [limit order display] because the price discovery process will be enhanced, market transparency will be improved and price competition will be promoted. By their very nature, these benefits are broad-based and pervasive.

Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995).

Accordingly, FINRA filed a proposal to restructure the existing minimum quotation tiers to allow for, among other things, an increased number of customer limit orders to be displayed. The SEC published the proposed rule change in the *Federal Register* for notice and comment and received five letters from four commenters.⁴ Of the four commenters, two supported the proposal, while two opposed it. The two supporting commenters, both individual investors, stated, among other things, that the proposal is a beneficial initiative and a step in the right direction to improve the quality of the over-the-counter marketplace.⁵ The two opposing commenters are industry participants, both of which put forth a myriad of claims regarding potential market structure and other impacts of the proposal, which we conclude are incorrect, unsubstantiated or have no direct connection to the instant filing.⁶ We discuss below two of the opposing comments that we consider germane to a consideration of the merits of this proposal, and then summarize the numerous other comments included in these letters and their lack of relevance to this filing. We also reiterate concerns previously raised in an e-mail to SEC Trading and Markets staff regarding the Exchange Act's Rule 19b-4⁷ process.⁸

First, one of the opposing commenters states that the proposal has not been shown by FINRA to benefit investors.⁹ In furtherance of this assertion, the commenter indicates that modifying the tier sizes to facilitate display of customer limit orders is unnecessary because broker-dealers aggregate multiple investors' orders until, together, they meet the current

⁴ Letters from Suzanne H. Shatto, Seattle, Washington, dated October 20, 2011 ("Shatto letter"); Naphtali M. Hamlet, Seattle, Washington, dated October 21, 2011 ("Hamlet letter"); Daniel Zinn, General Counsel, OTC Markets Group, Inc., dated November 10, 2011 ("OTC Markets letter"); Michael T. Corrao, Managing Director, Knight Capital Group, Inc., dated November 16, 2011 ("Knight letter"); and R. Cromwell Coulson, President and CEO, OTC Markets, dated November 18, 2011 ("Coulson letter").

⁵ See Shatto letter and Hamlet letter.

⁶ See OTC Markets letter, Knight letter and Coulson letter.

⁷ 17 CFR 240.19b-4.

⁸ See email from Marc Menchel to SEC staff at <http://www.sec.gov/comments/sr-finra-2011-058/finra2011058-6.pdf>.

⁹ See OTC Markets letter.

market-maker tier size minimums.¹⁰ Similarly, with respect to FINRA's estimation that the proposed rule change would increase customer limit order display from approximately fifty percent of customer orders to ninety percent, this commenter asserts that the true level of display of customer limit orders under the existing tiers already is in line with ninety percent as a result of such aggregation, although admitting this assertion is not based on an evaluation of data.¹¹

FINRA disagrees with this comment. Currently, approximately 10,000 OTC equity securities are quoted on inter-dealer quotation systems, and many of these securities trade infrequently and at widely varying volume levels each day.¹² We find the suggestion that transparency of customer limit orders should be dependent upon the expectation that other customer limit orders in the same security will be placed at the same price and around the same time to be incorrect. In fact, since its effectiveness in May of this year, and consistent with our previous calculation, a more recent sample of relevant data indicates that approximately 50% of customer limit orders for OTC equity securities priced between \$0.51 and \$1.00 meet the current tiers, whereas approximately 90% of those orders would have met the proposed tier sizes had they applied. Thus, FINRA continues to believe that this proposed rule change is an important investor-protection initiative.

Second, one opposing commenter includes in their letter a table comparing the minimum dollar values (*i.e.*, minimum quotation size multiplied by the price) associated with the existing tier sizes versus the proposed tier sizes, and states that there is a significant decrease in dollar values that may create unspecified operational and trading risks.¹³ As an initial matter, FINRA notes that the commenter's table inaccurately aligns within the same row different tiers and dollar amounts. For example, one row compares the current rule's minimum quotation size for OTC equity securities priced between fifty one cents (\$0.51)

¹⁰ “[FINRA’s] analysis ignores FINRA’s own rules, under which a market maker that receives customer limit orders is required to aggregate those orders for purposes of the limit order display rule. If the orders, as aggregated, would satisfy the minimum quotation requirements of Rule 6433 for a security, the market maker must publish the aggregated orders in any interdealer quotation system in which it is publishing quotations for that security. FINRA’s simplistic analysis fails to take account of the aggregation requirement, and as a result the statistics it cites in support of the Proposed Rule are grossly inaccurate.” *See* OTC Markets letter.

¹¹ “OTC Markets Group does not have access to the data contained in OATS, but we believe FINRA’s simplistic analysis is flawed on its face. . . . We believe the percentage of limit orders displayed under current Rules are already in line with the percentage of limit orders FINRA estimates would be published under the Proposed Rule.” *See* OTC Markets letter.

¹² Based on a recent review of quotation and trade data for OTC equity securities over a two-week period, less than 3% of OTC equity securities with a priced quotation trade one hundred or more times per day.

¹³ *See* Knight letter.

and one dollar (\$1.00) with the proposed minimum size for securities priced between two cents (\$0.02) and up to twenty six cents (*i.e.*, up to \$0.2599).¹⁴ This commenter, nonetheless, concludes that the table illustrates “the significant decrease in the dollar value of liquidity that market makers would be *required*¹⁵ to offer at each tier level.”¹⁶

To evaluate the impact of the proposed rule change on minimum dollar values, one must compare the current tiers and proposed tiers at particular price points or across comparable price ranges. Thus, we present a comparison of a selection of similar price points and ranges below:

Resulting Contract Value under Current Rule	COMMON PRICE POINT	Resulting Contract Value under Proposed Rule	Increase/Decrease
\$50.00	\$0.01/share	\$100.00	↑
\$99.50	\$0.0199/share	\$199.00	↑
\$1,750.00	\$0.35/share	\$175.00	↓
\$2,500.00	\$1.00/share	\$100.00	↓
\$10,001.00 to \$17,499.00	\$100.01/share to \$174.99/share	\$10,001.00 to \$17,499.00	=
\$17,500.00 to 12,500.00	\$175.00 to \$2,500.00	\$175.00 to \$2,500.00	↓

As shown above, the proposed rule would both increase and decrease dollar values depending upon the price point being evaluated, but would accomplish an overall result that is better for investors, more consistent with the national market system and that represents more meaningful minimum displayed liquidity at the lowest tiers (*i.e.*, doubling the minimums for all OTC equity securities priced under \$0.02/share).

Thus, FINRA is unclear as to how the significant negative impacts suggested by commenters would result from the proposal, such as “a significant risk that it will degrade market quality” and the “far-reaching effects on liquidity and efficiency of the OTC market.” The opposing commenters have provided no analysis or clear explanation that

¹⁴ *Id.*

¹⁵ See Knight letter. *Emphasis added.* FINRA notes that the current and proposed versions of the rule set forth minimums and do not prohibit market makers from quoting above those levels.

¹⁶ See Knight letter.

would indicate the likelihood of a nexus between such harms and the proposal.¹⁷ As discussed in more detail below, both opposing commenters instead ask that the Commission expend valuable resources to undertake an economic analysis into these supposed impacts and risks.¹⁸

FINRA believes it has provided sufficient information regarding the likely impact of the proposed rule change (*i.e.*, more customer limit orders can be displayed, which will

¹⁷ FINRA discussed the opposing comments in its November 30th e-mail to the staff of Trading and Markets, including comments regarding the impact on costs and liquidity:

Knight avers that the proposal will reduce liquidity because of the reduction of mandatory quotes sizes and increase trading and clearing costs because more transactions will be needed to accomplish executions. On its face the comment letter is curious because it does not answer the question as to why market participants would reduce their quote size simply because the rule proposal provides that option but doesn't mandate smaller quote sizes; especially if it is uneconomic to market participants to process smaller size orders. In addition the idea of additional costs to process more orders is similarly curious. The clearing business in securities is predicated on the fact that once a firm has sunk costs to clear transactions, the incremental cost of each additional transaction becomes negligible. Indeed, it is probably difficult for a firm to actually quantify the exact incremental dollar cost of clearing additional trades, but even ascertaining that fact would be of little import because Knight leaves out that a commission or mark-up (down) attaches to each trade that compensates Knight beyond its costs.

. . . As noted in our filing, lower quote sizes would allow for greater limit orders to be displayed. A potential greater number of limit orders increases price competition in the marketplace and we are unaware of any market in which greater competition has led to less liquidity. In NMS securities the role of the market maker has been radically reduced yet liquidity in NMS securities appear intact. It is hard to believe that allowing investors to better protect the pricing of their orders would dampen liquidity in the unlisted OTC Market. As to transaction costs, OTC Market raises an issue that has no nexus to the this rule filing, limit orders allows the investing public to control the prices at which they execute their transactions not their execution costs. FINRA's Mark-up rule governs the level of execution costs and its terms are unaffected by this rule.

See email from Marc Menchel to SEC staff at <http://www.sec.gov/comments/sr-finra-2011-058/finra2011058-6.pdf>.

¹⁸ See OTC Markets letter, Knight letter and Coulson letter.

result in increased price transparency), which FINRA has already discussed in the filing itself.¹⁹ Further, it is essential to note that the rule being amended only prescribes the *minimum* sizes required for display, such that market makers may choose to display a quotation sized either at the new minimum or in excess of the minimum and of course, are free to trade at sizes larger than the minimums, as they do today. FINRA believes that retail investors whose order sizes may be smaller than market makers' stand to benefit from this rule change.

As noted above, the opposing commenters also include comments that are, in substance, not germane to a consideration of the merits of this proposal. For example, one commenter repeatedly criticizes the recent extension of certain national market protections to quoting and trading on the over-the-counter markets, including the provision restricting subpenny quoting (commonly referred to as "minimum increments" or "tick sizes").²⁰ FINRA does not see, and the commenter does not explain, the nexus between the instant proposal and tick sizes. Likewise, the other opposing commenter complains about and calls for an economic analysis of, among other things, locked and crossed markets, access fees and other issues, but fails to provide a relationship between those issues and this proposal.²¹ Presumably, the commenter is hoping an analysis may yield such a nexus.

¹⁹ See Notice of Filing of SR-FINRA-2011-058.

²⁰ We strongly refute FINRA's dogmatic reasoning that all NMS-principled rules – developed to govern trading in the largest issuers – should be applied to the OTC market, where small, development stage companies often trade. FINRA has provided no compelling evidence to bolster its argument in favor of instituting NMS rules in the OTC market. Recently, prominent commentators have persuasively argued in the press that NMS rules cause severe harm to the trading markets for smaller companies. There have also been distinguished academics recommending higher minimum increments in less liquid securities.

See OTC Markets letter. FINRA notes that the NMS-principled rules were approved by the Commission on June 22, 2010, including a provision related to minimum increments/tick sizes. Therefore, the above argument substantively is unrelated to the instant filing and moot in that these NMS-principled rules already have been approved by the Commission and become effective. See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010) ("Order Approving File No. SR-FINRA-2009-054").

²¹ See Knight letter.

Finally, the standards for approving FINRA's proposed rule change are set forth in the Exchange Act, and must not be modified arbitrarily.²² As discussed above, one opposing commenter raises a number of unrelated arguments regarding certain other FINRA rules²³ and suggests, without basis, the existence of an unspecified connection between the proposal and market quality.²⁴ The commenter does admit that no basis for these assertions was provided, but states that an analysis and relevant information would be forthcoming within a week of its letter.²⁵ However, it has been more than a month and no further communication from this commenter appears in the Commission's online comment file, except a very short note with the subject line of "Help - We need an economist to review this change."²⁶ In this brief note, the commenter again asserts additional unclear and unsubstantiated connections to the proposed rule change (concerning Congressional efforts relating to small businesses), again promises to provide the Commission with "another [comment letter] shortly that has a bit more analysis," but then requests that the government perform an economic analysis – the objective of such an undertaking being dubious and unclear.

In its November 30th e-mail to the staff of Trading and Markets, FINRA discussed, among other things, the dangers of the Commission veering from the Exchange Act standards and giving undue weight to vague and unsupported assertions, and reiterates those concerns here.²⁷ In this case, a comment letter submitted on the last day of the comment

²² As stated in the filing, FINRA believes that the proposed rule change is consistent with the provisions of Sections 15A(b)(6) and (11) of the Exchange Act which require, among other things, that FINRA rules include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange. *See* Section 15A(b) of the Exchange Act.

The Exchange Act further provides that the Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. *See* Section 19(b) of the Exchange Act.

²³ *See* OTC Markets letter.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *See* Coulson letter.

²⁷ *See* email from Marc Menchel to SEC staff.

FINRA has engaged in the public comment process over course of its existence. We not only support its role in the federal securities laws but we routinely publish our rule proposals in Regulatory Notices seeking public comment before any filing with the Commission. Nevertheless, we think the question remains what is the standard of review by the Commission as to public comments? In this case, two commenters make unsupported, at points unrelated and somewhat vague comments that on their face raise questions and one of the commenters ask the Commission

period promising more data at some point in the near future, along with a subsequent e-mail requesting that the SEC perform a study itself with another vague promise of data to come, appears to have been designed to prolong or even halt the rulemaking process. This cannot be the intended standard of review for public comments and it degrades the value of the majority of comment letters submitted to the Commission on proposed rule changes.

FINRA believes that the opposing comments to this proposed rule change neither warrant modification to the proposal nor delay of its approval, and urges the Commission to approve the filing.

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FINRA believes that the foregoing responds to the material issues raised in the comment letters to this rule filing. If you have any questions, please contact me at (202) 728-8176 or Racquel L. Russell at (202) 728-8363.

Sincerely,



Stephanie M. Dumont
Senior Vice President and Director of
Capital Markets Policy

to do the commenter's homework. After all, no SRO is required to undertake an economic analysis of its rule proposals, but it is charged with not burdening competition with rules that are not in furtherance or in conformity with the Securities Exchange Act. FINRA takes that charge very seriously. Nonetheless, there is no statutory or Exchange Act Rule requirement to undertake an economic analysis because a commenter makes such demand and we are unaware of any requirement on the part of the Commission to oblige such commenters. Rather, it would seem that commenters should bear some burden beyond naked assertions that a rule would have a deleterious effect when those assertions are neither supported by reasoned argument and/or devoid of factual data.

<http://www.sec.gov/comments/sr-finra-2011-058/finra2011058-6.pdf>