

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

Direct: (202) 728-8176
Fax: (202) 728-8264

October 25, 2013

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2013-031 (Proposed Rule Change Relating to Participation on the Alternative Display Facility) – Response to Comments

Dear Ms. Murphy:

This letter is being submitted by Financial Industry Regulatory Authority, Inc. (“FINRA”) in response to comments submitted to the U.S. Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing (“Proposal”).¹

FINRA proposes to amend the requirements for members seeking registration as FINRA Alternative Display Facility (“ADF”) Market Participants in light of the migration of the ADF to the Multi Product Platform (“MPP”) (“ADF migration”). The Proposal, among other things, would require that a potential ADF Market Participant submit an ADF Deposit Amount of \$250,000, or \$500,000 if requesting accelerated ADF migration. The potential ADF Market Participant must agree to quote on and report trades to the ADF for a two-year term and to submit at least 75% of both its quote and trade volume to the ADF in order to earn back some or all of the ADF Deposit Amount through a credit structure based on the market data revenue associated with that member’s trade reporting activity on the ADF.

The Commission received one comment letter on the Proposal from the National Stock Exchange, Inc. (“NSX”).² NSX opposes the Proposal and argues that (1) FINRA has not demonstrated that the proposed ADF Deposit Amount and the accompanying credit provisions are reasonable and equitably allocated; and (2) the proposed ADF

¹ See Securities Exchange Act Release No. 70048 (July 26, 2013), 78 FR 4652 (August 1, 2013) (SR-FINRA-2013-031).

² See Letter to Elizabeth M. Murphy, Secretary, Commission, from David Harris, Chairman and CEO, NSX, dated September 9, 2013.

Deposit Amount and accompanying credit provisions, particularly the proposed 75% quoting requirement, impose a burden on competition that is not necessary or appropriate and may inappropriately impede competition among market participants.

FINRA disagrees with NSX's comments and believes that, as described in the Proposal, all aspects of the Proposal are consistent with the requirements of the Act. FINRA believes that the Proposal fairly and equitably balances the need to fund FINRA's costs associated with migrating and operating the ADF with the need to avoid unreasonable or unfair financial barriers to participation on the ADF. The issues raised by NSX are described and responded to below.

1. The Proposed ADF Deposit Amount and Credit Provisions are Reasonable and Equitable

NSX asserts that FINRA has failed to demonstrate that the proposed ADF Deposit Amount and accompanying credit provisions whereby an ADF Market Participant may earn back some or all of its ADF Deposit Amount are reasonable and equitably allocated, both with respect to ADF Market Participants and FINRA members that do not utilize the ADF. Specifically, NSX claims that the proposed ADF Deposit Amount does not take into account the ADF Market Participant's projected volume or capacity usage and states that FINRA should provide additional information on the cost of developing the ADF, the relation between the ADF Deposit Amount and the development costs associated with the ADF migration, and future fees to be charged to ADF Market Participants.

FINRA has sufficiently demonstrated that the ADF Deposit Amount is reasonable. As stated in the Proposal, the purpose of the ADF Deposit Amount is to help FINRA defray the costs associated with a new ADF Market Participant, with a higher amount where ADF migration is accelerated. The Proposal seeks to accomplish this goal by requiring that members directly responsible for those costs pay a larger share. As noted in the Proposal, FINRA conservatively estimates that the cost of an accelerated ADF migration (which scenario has been raised by certain FINRA members) will be in excess of \$3 million. In light of the projected total costs for the ADF migration, FINRA believes that the ADF Deposit Amounts of \$500,000 for ADF Market Participants requesting accelerated migration and \$250,000 for other ADF Market Participants are reasonable, particularly given that these amounts (1) represent a portion of the costs FINRA will incur and (2) are recoverable, in whole or in part, by the ADF Market Participant.³ In establishing these amounts, FINRA considered both the need to recover

³ In establishing the amount of the fee, FINRA also considered the fact that an ADF Market Participant's ability to earn back the ADF Deposit Amount and the timeframe in which it can be earned back are dependent upon the participant's trade volume. FINRA believes it has set the amount of the fee at a level that will ensure that most, if not all, ADF Market Participants can earn back the entire fee within the two-year commitment period provided the ADF Market Participant meets its commitments.

the costs associated with migrating and operating the ADF and the need to prevent the financial commitment, even if temporary, from precluding participation on the ADF by potential participants.

FINRA has also demonstrated that the proposed ADF Deposit Amount is equitably allocated. As stated in the Proposal, the ADF Deposit Amount will be assessed equally among ADF Market Participants, depending upon whether the ADF Market Participant is requesting, or benefitting from, accelerated ADF migration. While NSX argues that the proposed ADF Deposit Amount does not take into account the ADF Market Participant's projected volume or capacity usage, FINRA notes that a significant portion of the expenses associated with the ADF migration are not dependent upon an ADF Market Participant's proposed capacity usage, but are rather fixed costs that do not vary by market participant.

The ADF Deposit Amount must be submitted only by FINRA members that wish to become ADF Market Participants. Nonetheless, NSX questions whether the ADF Deposit Amount is equitably allocated to FINRA members that are not ADF Market Participants, notwithstanding that those members will not incur any fees under the Proposal. The primary objective of the ADF Deposit Amount is to enable FINRA to defray the costs it incurs in connection with a new ADF Market Participant and to equitably apportion those costs among ADF Market Participants, if applicable. To that end, FINRA is proposing to assess a higher fee on an ADF Market Participant that makes a request for an accelerated ADF Migration to defray the increased costs to FINRA resulting from accelerated migration.⁴

NSX suggests that FINRA should pass on all of the costs associated with developing and operating the ADF to new ADF Market Participants, so that FINRA members that are not ADF Market Participants will not have to bear such costs.⁵ The ADF serves an important purpose for FINRA in fulfilling its statutory obligations, including under Section 15A(b)(11) of the Act and, as such, FINRA must operate the ADF, even at a loss. The purpose of the ADF Deposit Amount is to help FINRA defray the costs associated with a new ADF Market Participant. If, as NSX suggests, FINRA were to impose all of the costs related to developing and operating the ADF on a new ADF Participant, this could discourage, or even prevent, new ADF Market Participants

⁴ FINRA would also assess the higher ADF Deposit Amount on an ADF Market Participant that benefits from the accelerated migration by quoting on, or reporting trades to, the ADF within 90 calendar days of an ADF Market Participant that requested accelerated ADF migration begins quoting on, or reporting trades to, the ADF.

⁵ FINRA notes that, although NSX urges the Commission not to approve the Proposal, if the Proposal is not approved, FINRA will still incur all of the costs associated with migrating and operating the ADF, with no potential offset from a new ADF Market Participant through the ADF Deposit Amount.

from joining the ADF and reduce potential ADF revenue, ultimately resulting in higher ADF-related losses. FINRA believes the ADF Deposit Amount, and the participant's ability to earn back the fee, strikes an appropriate balance between helping to defray the costs of migrating and operating the ADF while not making participation in the ADF cost-prohibitive.⁶ Accordingly, FINRA believes the proposal is an equitable allocation among ADF Market Participants and its members.

NSX asserts that "FINRA assumes that it is equitable for all member firms to fund the ADF platform regardless of whether that member uses the facility [and that] FINRA provides no basis for this assumption." The Proposal rests on no such assumption. In fact, the primary motivation behind the Proposal rests on precisely the opposite assumption: that a member that is primarily responsible for costs FINRA must incur must assume responsibility for a larger proportion of those costs. As FINRA stated in the Proposal, "FINRA . . . believes that requiring individual members to ensure the recoupment of a portion of the specific costs FINRA incurs to accommodate their request to accelerate the migration of the ADF or use the ADF is a fair and equitable way to ensure that the members responsible for those costs are accountable should they not participate on the ADF to the extent anticipated."

FINRA also believes that the provision through which an ADF Market Participant may earn back some or all of its ADF Deposit Amount through a credit structure based on market data revenue associated with the ADF Market Participant's activities is reasonable and equitably allocated.⁷ While this provision allows a member to potentially

⁶ NSX's suggestion that FINRA assess a fee on ADF Market Participants to entirely defray the cost of the ADF migration and operation raises other issues as well. If FINRA were to assess such a fee on the first ADF Market Participant, and continued to assess that same fee on subsequent ADF Market Participants, FINRA could receive fee revenue that exceeds the stated purpose of the fee. If, however, FINRA were only to assess such a fee on the first ADF Market Participant, without adjustment to reflect subsequent ADF Market Participants, the first ADF Market Participant would be funding a disproportionate share of the costs of the ADF migration and operation for all subsequent ADF Market Participants. FINRA believes that such a fee structure would not be reasonable or equitable. In assessing the ADF Deposit Amount, FINRA is attempting to treat similarly situated ADF Market Participants equitably. Applying NSX's approach to defraying the cost of the ADF migration and operation raises the possibility of an inequitable result for either FINRA or ADF Market Participants.

⁷ Pursuant to this provision, an ADF Market Participant may earn back up to 80% of its ADF Deposit Amount prior to the end of a two-year term, and the remaining 20% of its ADF Deposit Amount upon expiration of that two-year term, through a credit structure based on market data revenue. Specifically, for every \$1.00 of market data revenue received by FINRA that is associated with that member's trade reporting activity on the ADF, the member shall receive \$0.50 out of escrow.

earn back 100% of its ADF Deposit Amount, the credit structure is tied to the ADF Market Participant's trade reporting activity on the ADF and is therefore designed to provide incentives for an ADF Market Participant to remain active on the ADF for a two-year period in order to recoup the entirety of its ADF Deposit Amount. In addition to providing ADF Market Participants with an ability to earn back the ADF Deposit Amount, activity on the ADF also generates market data revenue for FINRA to use to help defray the costs of migrating and operating the ADF.

Finally, several times in its letter, NSX indicates that the reasonableness of fees charged (as well as the potential burden on competition discussed below) under the Proposal cannot be evaluated until FINRA discloses the fees it intends to charge for quoting and transaction reports. As an initial matter, FINRA disagrees with the assertion that a proposal must include a forecast of all future fees in order for the SEC to properly conclude the proposal is consistent with the Act. FINRA is not aware of any such requirement in the Act, and if one did exist, it would be difficult, if not impossible, to comply with given that such fees would, at best, be speculative in nature as they must, themselves, be subject to a separate SEC rule filing. However, in any event, NSX is likely unaware that there already are in place FINRA quote and transaction fees that are applicable to ADF Market Participants.⁸ To the extent that FINRA may in the future propose changes to those ADF fees, such changes will be made through a separate rule filing.⁹

2. The Proposed ADF Deposit Amount and Credit Provisions Do Not Pose any Burdens on Competition That are Not Necessary or Appropriate

NSX claims that, with the proposed ADF Deposit Amount and accompanying credit provisions, FINRA is subsidizing the operation of the ADF and such subsidy imposes a burden on competition both with respect to other ADF Market Participants and with respect to other market participants such as other self-regulatory organizations. In evaluating whether FINRA proposes to offer the ADF at a subsidized rate, NSX states that FINRA should include in its proposal the actual cost of developing the ADF platform, along with the transaction charges that it intends to collect from ADF Market Participants. NSX also asserts that the requirement that ADF Market Participants send

⁸ See FINRA Rule 7500 et seq.

⁹ Similarly, NSX also believes FINRA should be required to produce additional information to assess the reasonableness of the ADF Deposit Amount, such as the exact cost of the development and operation of the ADF and projected volume from any future potential ADF Market Participants. Again, FINRA does not believe that is a reasonable request or useful exercise in evaluating these fees, as the information that NSX would have FINRA provide would be entirely speculative in nature (e.g., FINRA cannot ascertain at this time how many ADF Market Participants will ultimately be assessed the ADF Deposit Amount, or in what amount, or what their future ADF volume would be).

75% of their quotes and trades to FINRA is an “unprecedented” burden on competition for any self-regulatory organization that is seeking to offer quote display for electronic communications networks (“ECNs”) and that NSX may not be able to compete with the ADF if a large ECN opted to switch to the ADF. NSX builds upon this analysis to further assert that if NSX were unable to compete, this would be a burden on competition amongst ECNs, since ECNs that currently post their quotes on NSX would be obligated to migrate to the ADF, or potentially cease their displayed business because the barrier to entry, e.g., paying the ADF Deposit Amount, would be excessive.

As discussed above, one of the objectives of the ADF Deposit Amount is to allow FINRA to recoup the expenses it incurs in connection with a new ADF Market Participant. FINRA believes that, for the reasons set forth above, the proposed ADF Deposit Amount is designed to reasonably and equitably allow FINRA to recoup costs related to the ADF migration and a new ADF Market Participant and does not result in an improper burden on competition.¹⁰ FINRA also strongly believes that the 75% requirement does not impose a burden on competition that is not necessary or appropriate and disagrees with NSX’s statements about the adverse effect of this quoting requirement on other market participants such as SROs and ECNs.¹¹ Contrary to NSX’s characterization, this quoting requirement is not a global requirement that must be satisfied in order to remain an ADF Market Participant; rather, it is narrowly linked to the ability of the ADF Market Participant to earn back some or all of its ADF Deposit Amount.¹² Therefore, it would be voluntary and at the discretion of the ADF Market

¹⁰ As previously noted, while an ADF Market Participant can earn back some or all of its ADF Deposit Amount through a credit structure based on market data revenue, this will not function as a subsidy either, as an ADF Market Participant will only earn back some or all of its ADF Deposit Amount based on the market data revenue FINRA receives that is attributable to that member’s trading activity on the ADF.

¹¹ FINRA also disagrees with the NSX’s broad statement about the potential effect of the 75% quoting requirement as it relates to an ADF Market Participant’s best execution obligation. Under the Proposal, an ADF Market Participant would lose its ability to recoup some or all of its ADF Deposit Amount if it submits quotes to, or reports trades on, the ADF that represent less than 75% of its total quoting and trading activity. Since this provision relates to the posting of quotes and the reporting of trades, and best execution implicates a broker-dealer’s handling of customer orders for execution, FINRA believes that NSX’s concern on this point is misplaced.

¹² As set forth in the Proposal, one-fifth of the ADF Deposit Amount shall be released to FINRA if, in any calendar month beginning with the fourth calendar month following certification of the ADF Market Participant to quote on or report trades to the ADF, the ADF Market Participant fails to submit 75% of the member’s quoting and trading activity to the ADF as agreed to by the member and FINRA.

Ms. Elizabeth M. Murphy
October 25, 2013
Page 7 of 7

Participant to determine, under the specific facts and circumstances of their trading system, what level of quoting and trading to send to the ADF. While voluntary, the Proposal, including the 75% requirement, is designed to provide incentives for an ADF Market Participant to quote and trade report on the ADF and utilize the ADF capacity that FINRA has incurred costs to provide, thereby reducing the likelihood of FINRA incurring unnecessary expenditures and increasing the probability of FINRA recouping a reasonable amount of the costs involved with launching a new ADF Market Participant.

* * * * *

FINRA believes that the foregoing fully responds to the issues raised by the commenter to the rule filing. Please contact me at (202) 728-8176 or Brant Brown at (202) 728-6927 if you have any questions.

Very truly yours,

A handwritten signature in black ink, appearing to read "Stephanie M. Dumont", with a long horizontal flourish extending to the right.

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