Regulatory Notice 18-29

OTC Equity Trading

FINRA Reminds Firms of Their Obligations When Effecting OTC Trades in Equity Securities on a Net Basis

Summary

FINRA is issuing this *Notice* to remind firms of their obligations under the FINRA trade reporting rules and other applicable FINRA and Securities and Exchange Commission (SEC) rules when effecting over-the-counter (OTC) trades in equity securities[1] on a "net" basis.

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Background and Discussion

The term "net" trading generally refers to contemporaneous principal transactions where the initial and offsetting transactions are at different prices.[2] For example, a firm trades on a "net" basis when it accumulates a position at one price and executes the offsetting trade with its customer or broker-dealer client at another price.[3] These trades may otherwise be considered riskless principal transactions, except the initial and offsetting transactions are effected at different prices. As such, they do not constitute riskless principal transactions within the specific definition of that term under FINRA equity trade reporting rules.

FINRA rules do not prohibit net trading or mandate the prices at which firms must execute the initial and offsetting transactions.[4] However, if a firm chooses to trade on a net basis, it must comply with all applicable rules, including, but not limited to, the FINRA trade reporting rules, FINRA Rules 2124 (Net Transactions with Customers), 2121 (Fair Prices and Commissions), 5310 (Best Execution and Interpositioning) and 5320 (Prohibition Against Trading Ahead of Customer Orders), and SEC Rule 611 under Regulation NMS (Order Protection Rule). As discussed below, firms must apply all such rules based on the net price of the transaction.[5]

FINRA

Financial Industry Regulatory Authority

September 12, 2018

Notice Type

- Guidance

Suggested Routing

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

Key Topics

- Alternative Display Facility (ADF)
- Best Execution
- Interpositioning
- Net Transactions
- NMS Stocks
- OTC Reporting Facility (ORF)
- OTC Equity Securities
- Riskless Principal Transactions
- Trade Reporting
- Trade Reporting Facilities (TRFs)

Referenced Rules & Notices

- FINRA Rules 2010 and 2020
- FINRA Rules 2121 and 2124
- FINRA Rules 5210, 5310 and 5320
- FINRA Rules 6282, 6380A, 6380B and 6622
- FINRA Rules 7130, 7230A, 7230B and 7330
- Securities Exchange Act Rule 10b-10
- Securities Exchange Act Rule 611
- Regulatory Notices 12-13 and 09-58
- Notices to Members 06-47, 99-65 and 95-67

Trade Reporting Requirements Applicable to Riskless Principal and Net Transactions

As an initial matter, FINRA trade reporting rules require that when reporting OTC trades in equity securities to a FINRA facility,[6] firms must report the price of the trade exclusive of commissions, mark-ups and mark-downs.[7] The following example is set forth in the rules: Firm 1 sells as principal 100 shares to a customer at $40.10, which includes a $0.10 mark-up from the prevailing market at $40. Firm 1 must report 100 shares at $40.[8]

In addition, FINRA trade reporting rules govern the reporting of riskless principal transactions, where the initial transaction and the offsetting transaction are effected at the same price.[9] Firms can report OTC riskless principal transactions by submitting a single report to a FINRA facility for public dissemination purposes (or "tape" report) in the same manner as an agency transaction, marked with a "riskless principal" capacity indicator, excluding any commission or mark-up/mark-down.[10] Alternatively, members can report an OTC riskless principal transaction by submitting two (or more, as necessary) reports: (1) a tape report to reflect the initial leg of the transaction with a capacity of principal; and (2) a non-tape (non-tape/non-clearing or non-tape/clearing-only) report to reflect the offsetting "riskless" leg of the transaction with a capacity of riskless principal.[11] Where the tape report for an OTC riskless principal trade reflects a capacity of "principal," the non-tape report is required under FINRA trade reporting rules. Irrespective of the chosen reporting method, only one leg of a riskless principal transaction is reported for public dissemination purposes.

As noted above, a net trade may otherwise be considered a riskless principal transaction, except that the initial and offsetting transactions are effected at different prices. As such, both transactions must be reported to a FINRA facility for public dissemination purposes.

Net transaction example:

Firm 1 receives a buy order and purchases the security from Firm 2 at $40. In the above example of a riskless principal transaction, the firm sells the security at $40 and charges a separate mark-up. In a net transaction, however, to satisfy the original buy order, Firm 1 sells the shares for $40.10 per share. In this example, both trades must be reported for public dissemination purposes: the trade at $40 between Firms 1 and 2, and the sale from Firm 1 to satisfy the original buy order at the net price of $40.10.

Firms are reminded that they should not submit a second tape report if the offsetting transaction is at the same price as the initial transaction. Firms must report the trade price as reflected on their books and records, and customer or execution confirmations, etc., and are prohibited from reporting the offsetting leg of a riskless principal trade inclusive of commission or mark-up/mark-down to a FINRA facility for purposes of facilitating clearance and settlement of the trade at the all-inclusive price.

Other FINRA and SEC Rules Applicable to Net Transactions

In addition to the FINRA trade reporting rules, firms that execute OTC transactions on a net basis must comply with all other applicable FINRA and SEC rules, including, but not limited to, the rules discussed below. Firms are reminded that they must apply applicable FINRA and SEC rules based on the net, *i.e.*, reported, price. In the net transaction example above, the net price of $40.10 is the execution price for purposes of determining compliance with applicable rules.

Customer Disclosure Obligations. Market makers that trade with customers on a net basis have disclosure and consent obligations under FINRA rules. Specifically, FINRA Rule 2124 requires a market maker to provide disclosure to, and obtain consent from, a customer prior to executing a transaction with a customer on a net basis. The disclosure and consent requirements under the rule apply only to market makers and differ depending on whether the market maker is trading with an institutional or non-institutional customer.[12]

For non-market makers, SEC Rule 10b-10(a) requires that firms disclose to customers, among other things, the difference between the price to the customer and the contemporaneous purchase (sale) price, where the firm, after having received an order to buy (sell) from a customer, purchases (sells) the security from another person to offset a contemporaneous sale to (purchase from) such customer.[13] Because this differential is separately disclosed on a customer confirmation under SEC Rule 10b-10(a), FINRA Rule 2124 does not impose disclosure and consent obligations on non-market makers.

SEC Rule 611 (Order Protection Rule). Firms trading on a net basis must comply with the Order Protection Rule, which requires trading centers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by automated trading centers, subject to applicable exceptions and exemptions. Accordingly, the net or reported price (*i.e.*, $40.10 in the above example) must not be inferior to a protected quotation, unless an exception or exemption applies.

SEC staff has provided the following guidance:

Q: A broker-dealer buys a block of an NMS stock as principal from a customer. Consistent with the broker-dealer's understanding with its customer, the trade price reported to the relevant SRO is lowered by two cents per share to compensate the block trading desk for committing its capital. Does this "net price" determine the price of the trade for all purposes under Rule 611?

A: Yes, the net price reported to the SRO (and thereafter disseminated in the Network data stream) is the price of the block trade for all purposes under Rule 611, such as determining whether a trade-through occurred and routing the necessary orders to execute against protected quotations to comply with the ISO exception.[14]

Fair Prices. Firms trading on a net basis with a customer must comply with Rule 2121 (Fair Prices and Commissions), which provides that if a firm buys (sells) for its own account from (to) its customer, the firm shall do so at a price that is fair, taking into consideration all relevant circumstances, including market conditions with respect to the security at the time of the transaction, the expense involved and the fact that the firm is entitled to a profit. The rule further states, in pertinent part, that it shall be deemed a violation of Rules 2010 (Standards of Commercial Honor and Principles of Trade) and 2121 for a firm to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security.[15]

Best Execution and Interpositioning. Firms trading on a net basis for or with a customer or a customer of another broker-dealer must comply with Rule 5310. As FINRA has previously stated, FINRA rules do not prohibit firms from reporting trades at two different prices of what essentially is a riskless principal trade, assuming the firm is complying with best execution obligations.[16] The net or reported price (*i.e.*, $40.10 in the above example) is used for purposes of assessing a firm's compliance with its best execution obligations.

Rule 5310(a)(1) requires a firm, in any transaction for or with a customer or a customer of another firm, to use "reasonable diligence" to ascertain the best market for a security and to buy and sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule identifies five factors that are among those to be considered in determining whether the firm has used reasonable diligence: (i) the character of the market for the security, including price, (ii) the size and type of the transaction, (iii) the number of markets checked, (iv) the accessibility of the quotation, and (v) the terms and conditions of the order as communicated to the firm.[17] Thus, factors of particular relevance in evaluating the offsetting transaction at the net or reported price may include the prevailing market price at the time of execution, as well as the terms and conditions of the order (*e.g.*, whether the customer consented to trade on a net basis).

Rule 5310 expressly applies to the handling of all customer orders, including those involving interposed third parties. Specifically, Rule 5310(a)(2) provides that in any transaction for or with a customer or a customer of another broker-dealer, no member firm shall interject a third party between the member firm and the best market for the security in a manner inconsistent with paragraph (a)(1) of the rule. Rule 5310(b) provides that when a member firm cannot execute directly with a market but must employ a broker's broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the member firm. For example, Firm 1 receives a buy order from a customer and routes the order to Firm 2 for handling and execution. Firm 2 purchases the shares on an exchange at $10 and executes the order from Firm 1 at $10.01. Firm 1, in turn, provides the shares to its customer at $10.01, the price it received from Firm 2. In this example, Firm 1 must demonstrate compliance with Rule 5310, including that the interpositioning of Firm 2 was acceptable under the circumstances.[18]

FINRA is reminding firms that, as discussed in *Regulatory Notice 09-58* (October 2009), interpositioning that is unnecessary or that violates a firm's general best execution obligations—either because of unnecessary costs to the customer or improperly delayed executions—is prohibited. Thus, the rule prohibits interpositioning that adversely affects the customer, and the cost to the customer remains a central part of determining whether a firm has met its best execution obligations.[19]

FINRA notes that pursuant to Rule 5310(e), the obligations under Rule 5310 exist not only where the firm acts as agent for the account of its customer but also where transactions are executed as principal. Rule 5310(e) further provides that such obligations are distinct from the reasonableness of commission rates, mark-ups or mark-downs, which are governed by Rule 2121 and its supplementary material.

Prohibition Against Trading Ahead of Customer Orders. Firms are reminded that the net or reported price of a net transaction will trigger their Rule 5320 obligations. Rule 5320 provides that, except as otherwise provided in the rule, a firm that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

Firms are reminded that in determining their obligation to execute a customer order under Rule 5320, the "benchmark" price is the net or reported price (*i.e.*, $40.10 in the above example)—not the reported price exclusive of the differential.[20] For example, Firm 1 is holding a customer limit order to sell 100 shares of security ABCD at $40.05. If, using the net transaction example above, the firm sells 1,000 shares of ABCD to another customer on a net basis at $40.10 (having bought the shares at $40), the firm would be required to execute the customer limit order to sell 100 shares, because the firm has reported a principal trade (*i.e.*, the trade at the net or reported price of $40.10) at a price that would satisfy the customer limit order at $40.05.[21]

FINRA notes that the exception for riskless principal transactions under Rule 5320.03 does not apply to net trades, because, as discussed above, the initial and offsetting legs of a net transaction are effected at different prices.

Inflated Trade Volume. FINRA has been advised that some firms may be improperly taking advantage of the net trade reporting requirements described above for the express purpose of inflating trading volume. Depending on the facts and circumstances, such conduct may be deemed a violation of FINRA rules, including, but not limited to, Rules 2010, 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 5210 (Publication of Transactions and Quotations) and 5310.

Conclusion

FINRA encourages firms to review their trading practices and policies and procedures, including written supervisory procedures, in the areas of trade reporting, customer disclosure and best execution and interpositioning, among others, to ensure that their net trading practices comply with applicable FINRA and SEC rules, including the rules discussed above.

Endnotes

1. Specifically, this *Notice* applies to OTC trades in NMS stocks, as defined under Rule 600(b) of SEC Regulation NMS, and OTC equity securities, as defined under FINRA Rule 6420. This *Notice* does not apply to transactions in fixed income securities.

2. *See, e.g.*, FINRA, Trade Reporting Frequently Asked Questions, FAQ #304.1, which states:

   A net trade is a principal trade in which a broker-dealer, after having received an order to buy (sell) an equity security, purchases (sells) the security at one price and satisfies the original order by selling (buying) the security at a different price.

3. *See* Securities Exchange Act Release No. 43103 (August 1, 2000), 65 FR 48774 (August 9, 2000) (Notice of Filing and Immediate Effectiveness of File No. SR-NASD-00-44).

4. *See, e.g.*, *Notice to Members 99-65* (August 1999), Attachment A, #6.

5. FINRA notes that certain rules applicable to net trading, for example, FINRA Rule 2124 and SEC Rule 10b-10 (Confirmation of Transactions), expressly distinguish between market makers and non-market makers and expressly apply only to transactions with or on behalf of a customer (*i.e.*, a non-broker-dealer). Therefore, the discussion of these rules in this *Notice* necessarily focuses on market makers versus non-market makers and customer orders, as applicable.

6. The FINRA facilities are the Alternative Display Facility (ADF) and two Trade Reporting Facilities (TRFs), which are used by firms to report OTC trades in NMS stocks, and the OTC Reporting Facility (ORF), which is used by members to report trades in OTC equity securities and transactions in restricted equity securities effected under Securities Act Rule 144A.

7. *See* FINRA Rules 7130(d)(3), 7230A(d)(3), 7230B(d)(3) and 7330(d)(3).

8. *See* FINRA Rules 6282(d)(3)(A), 6380A(d)(3)(A), 6380B(d)(3)(A) and 6622(d)(3)(A).

9. For purposes of OTC transaction reporting requirements applicable to equity securities, a "riskless principal" transaction is a transaction in which a member, after having received an order to buy (sell) a security, purchases (sells) the security as principal and satisfies the original order by selling (buying) as principal at the same price (the offsetting "riskless" leg). Generally, a riskless principal transaction involves two trades, the execution of one being dependent upon the execution of the other; hence, there is no "risk" in the interdependent transactions when completed. *See* FINRA, Trade Reporting Frequently Asked Questions, FAQ #302.1.

10. *See* Rules 6282(d)(3)(B), 6380A(d)(3)(B), 6380B(d)(3)(B) and 6622(d)(3)(B) (a riskless principal transaction shall be reported "excluding the mark-up or mark-down, commission-equivalent, or other fee"); *see also* *NTMs 99-65* (August 1999), *99-66* (August 1999) and *00-79* (November 2000).

11. *Id.*

12. *See* *Notice to Members 06-47* (September 2006).

13. 17 CFR 240.10b-10(a)(2)(ii)(A). Subparagraph (B) of that Rule requires broker-dealers acting as principal in any other transaction in an NMS stock to disclose the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer.

14. *See* SEC *Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, FAQ # 3.05*.

15. *See* Rule 2121.01.

16. *See* *Notice to Members 99-65* (August 1999) (stating that a firm is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price, provided that such arrangement satisfies the member's best execution obligations).

17. *See* Rule 5310; *see also* *Regulatory Notice 12-13* (March 2012) and *Regulatory Notice 09-58* (October 2009).

18. FINRA notes that Firm 2 also has an obligation under Rule 5310 (*i.e.*, a duty of best execution for the handling of the customer order from Firm 1).

19. *See* *Regulatory Notice 09-58* (October 2009).

20. *See, e.g.,* *Notice to Members 95-67* (August 1995).

21. *NTM 95-67* also provides guidance for members that accept limit orders from customers that incorporate a commission or mark-up/mark-down in the limit order price. For example, a customer enters a limit order to purchase security ABCD and requests that its total costs not exceed $10 per share, and the firm informs the customer that it charges a mark-up of $0.25. *NTM 95-67* provides that the firm may continue to purchase for its own account at $10 without also executing the customer order, because the customer order would be deemed a limit order at $9.75. FINRA notes that this example is not a net transaction, as defined above, and the reported trade price of the customer limit order execution would be $9.75, which is exclusive of the mark-up.