

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-67208; File No. SR-FINRA-2011-058)

June 15, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, to Amend FINRA Rule 6433 (Minimum Quotation Size Requirements for OTC Equity Securities)

I. Introduction

On October 6, 2011, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend FINRA Rule 6433 (“Rule”), which governs minimum quotation size requirements for OTC Equity Securities (“Original Proposal”).<sup>3</sup> The proposed rule change is intended to simplify the Rule’s price and size tiers; facilitate the display of customer limit orders under FINRA Rule 6460 (Display of Customer Limit Orders);<sup>4</sup> and expand the scope of the Rule. The proposed rule change was published for comment in the Federal Register on October 20, 2011.<sup>5</sup> The Commission received seven comment letters on the Original Proposal from four

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> “OTC Equity Security” means “any equity security that is not an NMS stock as that term is defined in Rule 600(b)(47) of SEC Regulation NMS; provided, however, that the term ‘OTC Equity Security’ shall not include any Restricted Equity Security.” See FINRA Rule 6420(e).

<sup>4</sup> See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010) (Order Approving NMS-Principled Rules for OTC Equity Securities) (“NMS-Principled Rules Approval Order”). FINRA Rule 6460 became operative on May 9, 2011.

<sup>5</sup> See Securities Exchange Act Release No. 65568 (October 14, 2011), 76 FR 65307 (“Notice”) (publication of Original Proposal). On November 17, 2011, FINRA consented to extending the time period for the Commission to either approve or disapprove the

separate commenters,<sup>6</sup> as well as two responses to the comment letters from FINRA.<sup>7</sup> On January 17, 2012, the Commission instituted proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>8</sup> to determine whether to approve or disapprove the proposed rule change.<sup>9</sup> The Order Instituting Proceedings was published for comment in the Federal Register on January 24, 2012.<sup>10</sup> The Commission received one comment letter in response to the Order Instituting Proceedings.<sup>11</sup> On April 17, 2012, FINRA filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for comment in the

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proposed rule change or to institute proceedings to determine whether to disapprove the proposed rule change to January 18, 2012.

<sup>6</sup> See Letter from Suzanne H. Shatto, dated October 20, 2011 (“Shatto Letter”); Letter from Naphtali M. Hamlet, dated October 21, 2011 (“Hamlet Letter”); Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. (“OTC Markets”) to Elizabeth M. Murphy, Secretary, Commission, dated November 10, 2011 (“OTC Markets Letter I”); Letter from Michael T. Corrao, Managing Director, Knight Capital Group, Inc. (“Knight”) to Elizabeth M. Murphy, Secretary, Commission, dated November 16, 2011 (“Knight Letter I”); Letter from R. Cromwell Coulson, President & CEO, OTC Markets to Craig Lewis and Kathleen Hanley, Commission, dated November 18, 2011 (“OTC Markets Letter II”); Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth M. Murphy, Secretary, Commission, dated December 29, 2011 (“OTC Markets Letter III”); Letter from Michael T. Corrao, Managing Director, Knight Capital Group, Inc. to Elizabeth M. Murphy, Secretary, Commission, dated January 13, 2012 (“Knight Letter II”).

<sup>7</sup> See Email from Marc Menchel, FINRA to John Ramsay, David S. Shillman, and Nancy J. Sanow, Division of Trading and Markets, Commission, dated November 30, 2011 (“FINRA Response I”) and Letter from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA to Elizabeth M. Murphy, Secretary, Commission, dated December 23, 2011 (“FINRA Response II”).

<sup>8</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>9</sup> See Securities Exchange Act Release No. 66168 (January 17, 2012) (“Order Instituting Proceedings”). On March 29, 2012, FINRA consented to extend the time period for the proceedings for the Commission to determine whether to approve or disapprove the proposed rule change to June 15, 2012.

<sup>10</sup> See Order Instituting Proceedings at 77 FR 3515. The comment period closed on February 14, 2012, and FINRA’s rebuttal period closed on February 28, 2012.

<sup>11</sup> See Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth M. Murphy, Secretary, Commission, dated February 14, 2012 (“OTC Markets Letter IV”).

Federal Register on April 20, 2012.<sup>12</sup> The Commission received two comment letters on the proposed rule change, as modified by Amendment No. 1.<sup>13</sup> On June 5, 2012, FINRA filed Amendment No. 2 to the proposed rule change.<sup>14</sup>

The Commission is publishing this Notice and Order to solicit comment on Amendment No. 2 and to approve the proposed rule change, as modified by Amendments Nos. 1 and 2 thereto, on an accelerated basis.

## II. Description of the Proposal

As described more fully in the Original Proposal, FINRA proposed changes to the minimum quotation sizes in FINRA Rule 6433 to, among other things, simplify the Rule's price and size tiers, facilitate the display of customer limit orders under FINRA Rule 6460,<sup>15</sup> and expand the Rule's scope.

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<sup>12</sup> See Securities Exchange Act Release No. 66819 (April 17, 2012), 77 FR 23770 (April 20, 2012). Amendment No. 1 revised the Original Proposal's minimum quote size requirements and proposed that the amended Rule operate as a pilot. The comment period for the Notice of Amendment No. 1 closed on May 7, 2012.

<sup>13</sup> See Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth M. Murphy, Secretary, Commission, dated May 7, 2012 ("OTC Markets Letter V"); Letter from Michael T. Corrao, Managing Director, Knight Capital Group, Inc. to Elizabeth M. Murphy, Secretary, Commission, dated May 7, 2012 ("Knight Letter III").

<sup>14</sup> In Amendment No. 2, as further described below, FINRA committed to provide specific data to allow the Commission to evaluate the impact of the proposed pilot on the over-the-counter ("OTC") equity market; responded to comments received on Amendment No. 1; and clarified certain statements in the Original Proposal and Amendment No. 1. Amendment No. 2 also clarified that the implementation date of the proposed rule change would be no sooner than 120 days following Commission approval and no later than 180 days following Commission approval. A copy of Amendment No. 2 is located in the Commission's public file for SR-FINRA-2011-058 at <http://www.sec.gov/comments/sr-finra-2011-058/finra2011058.shtml>.

<sup>15</sup> See NMS-Principled Rules Approval Order, supra note 4.

Currently, FINRA Rule 6433 requires every member functioning as an OTC Market Maker<sup>16</sup> that enters firm quotations into any inter-dealer quotation system that permits quotation updates on a real-time basis to honor those quotations for certain minimum sizes (“minimum quotation sizes”).<sup>17</sup> Rule 6433 sets forth the specific minimum quotation size requirements in tiers that are based on the price of the OTC equity security being quoted by the market maker. Further, FINRA Rule 6460 requires any OTC Market Maker displaying a priced quotation in an OTC equity security in an inter-dealer quotation system to publish immediately (subject to certain limited exceptions) a bid or offer that reflects: (1) the price and full size of a customer limit order that improves the market maker’s bid or offer; and (2) the full size of a customer limit order that: (a) is priced equal to the market maker’s bid or offer; (b) is priced equal to the best bid or offer of the inter-dealer quotation system in which the market maker is quoting; and (c) is more than a de minimus amount in relation to the size of the market maker’s bid or offer.

In its Original Proposal, FINRA explained that OTC Market Makers currently are not required to display a customer limit order unless doing so would comply with the minimum quotation sizes applicable to the display of quotations on an inter-dealer quotation system.<sup>18</sup> FINRA stated that the proposed rule change would benefit investors by facilitating the display of customer limit orders under Rule 6460, which generally requires that OTC Market Makers fully display better-priced customer limit orders (or same-priced customer limit orders that are at the

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<sup>16</sup> OTC Market Maker means “a member of FINRA 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 Act. A member 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(f).

<sup>17</sup> See Original Proposal, supra note 5.

<sup>18</sup> See Regulatory Notice 10-42 (September 2010).

best bid or offer and that increase the OTC Market Maker's size by more than a de minimus amount).<sup>19</sup>

Specifically, FINRA proposed that the minimum quotation size required for display of a quotation in an OTC equity security would fall into one of six tiers rather than the current nine tiers. Under the current rule, there are nine tiers as follows:

- \$2500.01 per share and above, the minimum quotation size is 1 share;
- \$1000.01 through \$2500.00 per share, the minimum quotation size is 5 shares;
- \$500.01 through \$1000.00 per share, the minimum quotation size is 10 shares;
- \$200.01 through \$500.00 per share, the minimum quotation size is 25 shares;
- \$100.01 through 200.00 per share, the minimum quotation size is 100 shares;
- \$10.01 through \$100.00 per share, the minimum quotation size is 200 shares;
- \$1.01 through \$10.00 per share, the minimum quotation size is 500 shares;
- \$0.51 through \$1.00 per share, the minimum quotation size is 2,500 shares;
- \$0.0001 through \$0.50 per share, the minimum quotation size is 5,000 shares.

Under FINRA's Original Proposal, the proposed six tiers would be as follows:

- \$175.00 per share and above, the minimum quotation size would be 1 share;
- \$1.00 through \$174.99 per share, the minimum quotation size would be 100 shares;

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<sup>19</sup> FINRA Rule 6460 was adopted as part of an effort to extend certain protections in place for NMS stocks to quoting and trading of OTC Equity Securities. See NMS-Principled Rules Approval Order, supra note 4. In approving FINRA Rule 6460, the Commission noted that "FINRA's limit order display proposal marks a positive step in efforts to improve the transparency of OTC Equity Securities and the handling of customer limit orders in this market sector." Id.

- \$0.51 through \$0.9999 per share, the minimum quotation size would be 200 shares;
- \$0.26 through \$0.5099 per share, the minimum quotation size would be 500 shares;
- \$0.02 through \$0.2599 per share, the minimum quotation size would be 1,000 shares;
- \$0.0001 through \$0.0199 per share, the minimum quotation size would be 10,000 shares.

Under Amendment No. 1, the proposed six tiers would be as follows:

- \$175.00 per share and above, the minimum quotation size would be 1 share;
- \$1.00 through \$174.99 per share, the minimum quotation size would be 100 shares;
- \$0.51 through \$0.9999 per share, the minimum quotation size would be 1,000 shares;
- \$0.20 through \$0.5099 per share, the minimum quotation size would be 2,500 shares;
- \$0.10 through \$0.1999 per share, the minimum quotation size would be 5,000 shares;
- \$0.0001 through \$0.0999 per share, the minimum quotation size would be 10,000 shares.

Amendment No. 1 would increase the minimum quotation sizes for most price points between \$0.02 and \$1.00 in comparison to the Original Proposal. Under Amendment No. 1, the proposed minimum quotation size for securities priced between \$0.02 and \$0.0999 would be

increased from 1,000 shares to 10,000 shares; between \$0.10 and \$0.1999 would be increased from 1,000 shares to 5,000 shares; between \$0.26 and \$0.5099 would be increased from 500 shares to 2,500 shares; and between \$0.51 and \$0.9999 from 200 shares to 1,000 shares, when compared to the Original Proposal. The proposed minimum quotation size for securities priced below \$0.02 would be 10,000 shares, which remains unchanged from the Original Proposal.

Based on its study of the Order Audit Trail System (“OATS”) data for OTC Equity Securities in connection with its Original Proposal, FINRA in its Original Proposal stated that the changes to the current tier sizes set forth in the Original Proposal would result in the display of a larger number of customer limit orders, potentially increasing from 50% to 90% the number of customer limit orders eligible for display, particularly for securities quoted between \$0.51 and \$0.9999 per share.<sup>20</sup> In Amendment No. 2, FINRA clarified that the sample it had referred to in the Original Proposal pertained only to securities priced between \$0.51 and \$1.00 per share.<sup>21</sup> In its Original Proposal, FINRA stated that, for securities priced at or above \$0.02 per share, the reduction in minimum quotation size requirements would cause a greater percentage of customer limit orders to be displayed.<sup>22</sup>

Based on a later study, as described in Amendment No. 1, FINRA stated that the revised tier sizes proposed in Amendment No. 1 would facilitate the display of additional liquidity by market makers in comparison to the Original Proposal and of a total of approximately 95% of all

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<sup>20</sup> See Original Proposal, supra note 5.

<sup>21</sup> See Amendment No. 2, supra note 14.

<sup>22</sup> See Original Proposal, supra note 5. For securities priced under \$0.02 per share, FINRA recognized that more substantive dollar-value commitments to the market would be required.

customer limit orders.<sup>23</sup> In addition, under the revised tiers described in Amendment No. 1, for securities priced from \$0.10 up to \$1.00, FINRA noted that the required minimum dollar value of displayed liquidity would range from \$500.00 to \$1,274.75, which are dollar amounts that, in FINRA's view, represent both the appropriate minimum dollar value of displayed liquidity for members and reasonable dollar values for customer orders to be eligible for display on an inter-dealer quotation system. In Amendment No. 2, FINRA stated that although its analysis of sample data showed that improved display of customer limit orders is most dramatic for those securities priced between \$0.51 and \$1.00 per share, it also found that, in the aggregate, a material increase in the number of displayable customer limit orders would be achieved with the new tier sizes.<sup>24</sup>

In the Original Proposal, FINRA stated that the proposed revisions to Rule 6433 were appropriate because they would simplify the price and size tier structure of the Rule and would facilitate the display of customer limit orders consistent with Rule 6460, while still recognizing the utility of requiring that quotes in lower-priced securities represent a minimum dollar-value commitment to the market. FINRA remarked that the revised proposed tiers, as described in Amendment No. 1, would increase the minimum quotation size requirements for OTC equity securities in comparison to the Original Proposal. In FINRA's view, the proposed tier sizes in Amendment No. 1 would increase the minimum dollar commitment to the market overall in

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<sup>23</sup> In Amendment No. 1, FINRA stated that it had analyzed a random sample of over 100 million customer limit orders in OTC Equity Securities that were reported to FINRA during a six-month period.

<sup>24</sup> Specifically, FINRA looked at a random sample of 32 trading days between May and December 2011 and found that the number of customer limit orders at or above the minimum tier size increased from approximately 85% of customer limit orders being at or above the minimum size to be eligible for display under the current tiers to 96% of customer limit orders being eligible for display under the tiers proposed in Amendment No. 1.



comparison to the Original Proposal, while still facilitating investor protection by providing for greater display of customer limit orders than occurs under the current Rule. FINRA contended that the revised tiers described in Amendment No. 1 would continue to yield the benefits discussed in its Original Proposal, including the simplification of the existing Rule by reducing the number of minimum quotation tiers and incorporating a minimum of quotation size of 100 shares for all securities priced at or above \$1.00, other than those priced at or above \$175.

FINRA also believed that the minimum quotation size requirements contained in its Original Proposal and the proposed revisions contained in Amendment No. 1 would benefit investors by increasing the percentage of customer limit orders that would be eligible for display under Rule 6460, thereby improving transparency and enhancing execution opportunities for customer limit orders. In Amendment No. 1, FINRA noted its view that the resulting increased display of customer limit orders would enhance competition and pricing efficiency in the market for OTC equity securities, which also should have a positive impact on capital formation.<sup>25</sup> In Amendment No. 1, FINRA further stated that the resulting increased display of customer limit orders would improve the public availability of quotation information, and increase quote competition, market efficiency, best execution and disintermediation.<sup>26</sup>

Currently, Rule 6433 applies to those member firms that function as market makers in OTC equity securities. In the Original Proposal, FINRA proposed to expand the scope of the Rule to apply to all quotations or orders displayed in an inter-dealer quotation system, including quotations displayed by alternative trading systems (“ATs”) or by non-market maker members representing customer trading interest.<sup>27</sup> FINRA noted that ATs have become increasingly

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<sup>25</sup> See Amendment No. 1, supra note 12.

<sup>26</sup> Id.

<sup>27</sup> The Commission notes that this proposal was not modified by Amendment No. 1.

active in the OTC market and believed that the proposed expansion of the scope of the Rule would ensure that minimum quotation sizes were observed consistently by all members displaying quotations on an inter-dealer quotation system.

FINRA remarked that other existing requirements and obligations would not be altered by its proposed rule change, as amended. According to FINRA, each member would continue to be required to honor its quotations for the full quantity displayed in accordance with FINRA Rule 5220 (Offers at Stated Prices), which generally provides that no member shall make an offer to buy or sell any security at a stated price unless such member is prepared to purchase or sell the security at such price and under such conditions as are stated at the time of such offer to buy or sell.<sup>28</sup> Likewise, member obligations pursuant to FINRA Rule 5210 (Publication of Transactions and Quotations) would continue to apply. Among other things, FINRA Rule 5210 generally prohibits members from publishing, circulating, or causing to be published or circulated, any quotation which purports to quote the bid price or asked price for any security, unless such member believes that such quotation represents a bona fide bid for, or offer of, such security.<sup>29</sup>

Under Amendment No. 1, the proposed rule change would be implemented for all OTC equity securities displayed on an inter-dealer quotation system on a pilot basis for a period of one year from the operative date of the proposed rule change. In the Original Proposal, FINRA stated that it would announce in a Regulatory Notice the operative date of the proposed rule change, which would be no later than 180 days following Commission approval of the proposed rule change. In Amendment No. 1, FINRA clarified that the operative date for the pilot would be 120 days following the date of Commission approval of the proposed rule change, as amended.

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<sup>28</sup> See also Rule 5220.01 (Firmness of Quotations).

<sup>29</sup> See also Rule 5210.01 (Manipulative and Deceptive Quotations).

In Amendment No. 2, FINRA further clarified that the operative date for the pilot would be no sooner than 120 days, and no later than 180 days, following the date of Commission approval of the proposed rule change, as amended. FINRA also has committed to provide the Commission with data to allow the Commission to evaluate the impact of the pilot program to revise the Rule's minimum quotation size requirements.<sup>30</sup>

### III. Comment Letters and FINRA's Responses

#### A. Comment Letters Received on the Original Proposal and FINRA's Responses Thereto

The Commission received seven comment letters from four commenters on the Original Proposal.<sup>31</sup> FINRA submitted two responses to those comment letters.<sup>32</sup>

The commenters on the Original Proposal generally were supportive of the goal of having additional limit orders eligible for display. However, OTC Markets and Knight objected to the proposed revisions to the minimum quotation size requirements of Rule 6433.<sup>33</sup> Specifically, these commenters expressed concern that FINRA's proposal lacked sufficient economic analysis to demonstrate that the proposed revisions to the minimum quotation size requirements would improve liquidity or lower transaction costs for investors.<sup>34</sup> A third commenter suggested that the minimum dollar value of each tier size should be \$100 as a means to provide greater transparency to all market participants.<sup>35</sup> A fourth commenter supported the proposal to the

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<sup>30</sup> See Amendment No. 2, supra note 14.

<sup>31</sup> See supra note 6.

<sup>32</sup> See supra note 7.

<sup>33</sup> See OTC Markets Letter I, Knight Letter I, OTC Markets Letter II, OTC Markets Letter III, and Knight Letter II.

<sup>34</sup> Id.

<sup>35</sup> See Shatto Letter.

extent that it would help prevent manipulative practices, but otherwise addressed topics unrelated to the proposal.<sup>36</sup>

Knight expressed the view that the proposal could have the unintended consequence of negatively impacting the market by removing meaningful minimum required dollar value levels of displayed liquidity by market makers.<sup>37</sup> According to this commenter, because the proposed levels are significantly lower than currently required levels, the proposal potentially could cause a severe degradation in trading efficiency, particularly in less liquid securities, and thereby fail to meet the proposal's desired goal.<sup>38</sup> Knight provided a table to detail the change to the minimum dollar value required to be displayed by market makers under the proposal.<sup>39</sup> According to Knight, its table illustrated a significant decrease in dollar value of liquidity that market makers would be required to offer at each tier level.

In addition, Knight believed that, under the proposal, market makers would be required to quote insignificant dollar values, thereby creating additional operational and trading risks, without providing real value to the market.<sup>40</sup> Knight further expressed concern that any increase in costs to liquidity providers could result in the departure of market makers and thereby could cause an erosion of liquidity.<sup>41</sup> Knight recommended further economic analysis to study the expected impact of the proposed tier sizes on market liquidity, and requested that the Commission conduct an analysis of the data.<sup>42</sup> Knight suggested that, if the Commission were

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<sup>36</sup> See Hamlet Letter.

<sup>37</sup> See Knight Letter I.

<sup>38</sup> See Knight Letter I at p.1.

<sup>39</sup> See Knight Letter I at p.2.

<sup>40</sup> See id.

<sup>41</sup> See id.

<sup>42</sup> See id.

inclined to move forward after such analysis, a limited pilot would allow for the assessment of the proposal's impact on market quality while minimizing the effects of any unintended consequences.<sup>43</sup>

In another communication, Knight reiterated its belief that the proposal would have serious negative consequences to the OTC marketplace and investors, including a significant reduction in liquidity, inferior pricing and increased vulnerability to gaming and frontrunning.<sup>44</sup> Knight expressed concern about the consequences likely to result when concepts and rules from the market for NMS securities were applied to the OTC equity market, despite differing trading characteristics between NMS securities and OTC equity securities.<sup>45</sup> Knight again requested that the Commission conduct a comprehensive analysis of empirical data to assess whether the proposal has a sound basis and evaluate the costs and benefits associated with the proposal.<sup>46</sup> Knight questioned how FINRA could evaluate its obligations under Section 15A(b)(9) of the Act<sup>47</sup> without performing a fundamental analysis of the proposal.<sup>48</sup> Knight pointed to the prior analysis performed by the National Association of Securities Dealers, Inc., FINRA's predecessor, in connection with tier size reductions in Nasdaq securities and suggested that FINRA consider a similar approach for its current proposal.<sup>49</sup>

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<sup>43</sup> See id.

<sup>44</sup> See Knight Letter II at p.1. Knight noted its agreement with the views expressed in OTC Markets Letter III. Id. Knight also included a modified version of the table that was included in its prior letter. See Knight Letter II at p.3.

<sup>45</sup> See id.

<sup>46</sup> See Knight Letter II at p.2.

<sup>47</sup> 15 U.S.C. 78o-3(b)(9).

<sup>48</sup> Id.

<sup>49</sup> See id. (citing Securities Exchange Act Release No. 40211 (July 15, 1998), 63 FR 39322 (July 22, 1998) (Order Approving a Proposed Rule Change to Permanently Expand the NASD's Rule Permitting Market Makers to Display Their Actual Quotation Size)).

Knight expressed the view that non-NMS securities are significantly less liquid than NMS securities and that the proposed rule change would have an adverse impact on both dealers and investors.<sup>50</sup> In Knight’s opinion, the only possible benefits resulting from the proposal would accrue to firms that provide little or no liquidity, as those firms would “pick-off” dealer liquidity at the expense of investors.<sup>51</sup> Knight further noted that market makers like itself generally do not charge commissions or mark-up/mark-downs to competitors or broker-dealer clients.<sup>52</sup> Knight indicated that market makers would continue to incur costs to access liquidity under the proposal and that there was a likelihood that market participants would gravitate to posting quotations at the minimum tier size as they currently do today.<sup>53</sup> Finally, Knight reiterated its concern that costs could increase for self-clearing firms under the proposal and that costs would be more burdensome in the case of non-DTCC eligible securities (i.e., physically settled securities) because those costs were driven by the number of settlements as opposed to the number of trades.<sup>54</sup>

OTC Markets expressed the view that the reduction of minimum quote size requirements “has not been shown by FINRA to benefit investors and has a significant risk that it will degrade market quality.”<sup>55</sup> OTC Markets further suggested that Regulation NMS-type rules are not appropriate in the context of smaller issuers.<sup>56</sup> In OTC Market’s view, the immediate effect of the proposal would be less displayed liquidity, even if the actual liquidity were larger, because

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<sup>50</sup> See Knight Letter II at pp.2-3.

<sup>51</sup> See Knight Letter II at p.3.

<sup>52</sup> See id.

<sup>53</sup> See id.

<sup>54</sup> See Knight Letter II at pp.3-4.

<sup>55</sup> See OTC Markets Letter I at p.1.

<sup>56</sup> See id.

quotations typically are submitted at the minimum size.<sup>57</sup> OTC Markets believed that this potential effect would lead to more volatility and would increase realized spreads because orders ultimately would be filled away from the inside quote, thereby raising the cost of trading.<sup>58</sup>

OTC Markets stated that the analysis provided by FINRA was not compelling, and cited to public commentators and academics that generally have suggested that Regulation NMS-type rules are harmful to the market for smaller companies' securities.<sup>59</sup> OTC Markets asserted that FINRA's statistical analysis concerning the additional percentage of customer orders that would be displayed under the proposed rule change was flawed because, among other things, FINRA did not consider the impact of its own quote aggregation rules.<sup>60</sup> OTC Markets believed, at a minimum, FINRA's analysis required further study,<sup>61</sup> and recommended that the Commission's staff review the actual effect of the proposed rule change on the display of limit orders.<sup>62</sup>

In another communication, OTC Markets again expressed the view that FINRA's analysis was flawed.<sup>63</sup> OTC Markets suggested that the proposal represented a large change in OTC market structure and could negatively impact capital formation for small businesses. Again, OTC Markets requested that the Commission's staff conduct its own economic analysis of the proposed rule change.

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<sup>57</sup> See OTC Markets Letter I at p.3.

<sup>58</sup> See id.

<sup>59</sup> See OTC Markets Letter I at p.2.

<sup>60</sup> See id.

<sup>61</sup> See id.

<sup>62</sup> See OTC Markets Letter I at p.3.

<sup>63</sup> See OTC Markets Letter II.

FINRA provided two response letters addressing issues raised by the commenters on the Original Proposal.<sup>64</sup> In both of its responses, FINRA noted that the purpose of allowing smaller displayed quotes was to allow for the greater use of limit orders by investors.<sup>65</sup> In FINRA Response II, FINRA reiterated that the Original Proposal was associated with the FINRA limit order display rule, which recently had provided a fundamental investor protection with respect to OTC equity securities.<sup>66</sup> FINRA explained that the existing minimum quotation sizes reduced the benefit of its limit order display rule because the higher existing levels “act to restrict transparency of a large number of customer limit orders.”<sup>67</sup> Addressing commenters’ concerns about reduced liquidity, FINRA noted that the lower minimum quote sizes described in the Original Proposal would allow for the display of a greater number of limit orders. FINRA believed that the larger number of quotes would increase competition, and increased competition would improve liquidity.<sup>68</sup> FINRA noted that, although the role of the market maker had been reduced in the trading of NMS securities, liquidity in those securities appeared intact.<sup>69</sup> FINRA remarked that, to the extent that commenters were concerned that the processing of smaller quotes would be uneconomical, the proposed rule change would not mandate the use of smaller quote sizes.<sup>70</sup>

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<sup>64</sup> See supra note 7.

<sup>65</sup> See FINRA Response I at p.1.

<sup>66</sup> See FINRA Response II at p.1.

<sup>67</sup> Id.

<sup>68</sup> See FINRA Response I at p.1 and FINRA Response II at p.5, n.17. Knight and OTC Markets stated that market makers might react to the proposed rule change by reducing their quote sizes. See Knight Letter I at pp.1-2 and OTC Markets Letter I at p.3.

<sup>69</sup> See FINRA Response I at p.1.

<sup>70</sup> See FINRA Response I at p.1 and FINRA Response II at p.5, n.17. Knight believed that there would be costs associated with the operational complexity of clearing increased volumes of smaller trades in non-DTC eligible securities. See Knight Letter I at p.2.



In FINRA Response II, FINRA disagreed with OTC Markets' suggestion that the percentage of customer limit orders currently displayed under Rule 6460 already was in line with FINRA's estimate of the number of customer limit orders that would be displayed under the proposal.<sup>71</sup> FINRA believed that, contrary to the commenter's assertion, broker-dealers were unlikely to be in a position to aggregate multiple customer orders to reach the existing display thresholds, because OTC equity securities trade infrequently and at widely varying volume each day.<sup>72</sup> FINRA also noted that, in any event, price transparency should not depend upon the expectation that other orders for OTC equity securities might be placed at the same price and at around the same time.<sup>73</sup> Finally, FINRA noted that a more recent sample of relevant data further supported its position that the proposed rule change would increase the display of customer limit orders from 50% under the existing minimum quotation size requirements to 90% under the Original Proposal in the case of OTC equity securities priced between \$0.51 and \$1.00.<sup>74</sup>

In FINRA Response II, FINRA stated its view that the chart contained in Knight Letter I did not accurately align tier and price points and therefore did not allow for an appropriate comparison of the current and proposed rules.<sup>75</sup> FINRA provided a comparison of similar price points and ranges to demonstrate that the Original Proposal would increase the dollar values for two proposed lower price point tiers and decrease dollar values for three proposed higher price

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OTC Markets believed that the proposed rule change would increase transaction costs for investors. See OTC Markets Letter I at p.3.

<sup>71</sup> See FINRA Response II at p.3. OTC Markets believed that the FINRA analysis failed to take into account aggregation requirements. See OTC Markets Letter I at p.2.

<sup>72</sup> See FINRA Response II at p.3.

<sup>73</sup> See id.

<sup>74</sup> See id.

<sup>75</sup> See FINRA Response II at pp.3-4.

point tiers, while the dollar values of one proposed price point tier would remain unchanged.<sup>76</sup>

FINRA believed that its proposed structure was better for investors; was more consistent with the national market system; and represented more meaningful minimum displayed liquidity at the lowest tiers.<sup>77</sup> FINRA disputed the suggestion in Knight Letter I that its proposal would degrade market quality or have far reaching effects on liquidity and efficiency in the OTC markets, noting again that the “opposing commenters have provided no analysis or clear explanation that would indicate the likelihood of a nexus between such harms and the proposal.”<sup>78</sup> FINRA reiterated that the likely impact of the proposed rule change would be greater displayed customer limit orders, as customer orders may be smaller than market maker orders, and that this increased display would result in increased price transparency.<sup>79</sup> FINRA noted that the Rule only prescribes the minimum sizes required for display, and that market makers may choose to display a quotation at the proposed minimum or in excess of the proposed minimum, as they do today.<sup>80</sup>

In FINRA Response II, FINRA further noted that several comments were not germane to the consideration of the merits of its proposal. For example, FINRA did not believe that there was a nexus between the proposal and the extension of certain other NMS protections to OTC

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<sup>76</sup> See FINRA Response II at p.4.

<sup>77</sup> See id.

<sup>78</sup> See FINRA Response II at pp.4-5.

<sup>79</sup> See FINRA Response II at pp.5-6.

<sup>80</sup> See FINRA Response II at p.6; see also FINRA Response I at p.1.

markets, as stated in the OTC Markets comments,<sup>81</sup> or between the proposal and issues such as locked or crossed markets and access fees, as suggested by Knight Letter I.<sup>82</sup>

OTC Markets reiterated its views regarding the proposal in its third comment letter, which was submitted following FINRA's responses to the comment letters.<sup>83</sup> The commenter again stated its view that Regulation NMS-type rules were not appropriate for the OTC market.<sup>84</sup> In addition, OTC Markets once more raised issues regarding FINRA's analysis. According to OTC Markets, FINRA's analysis did not reflect existing customer order aggregation requirements;<sup>85</sup> did not provide information regarding dollar and share volume relative to tier sizes;<sup>86</sup> and did not analyze the proposal's potential impact on market orders or proprietary quotes.<sup>87</sup>

OTC Markets remarked that FINRA's response letters failed to address Section 3(f) of the Act,<sup>88</sup> which requires that whenever, pursuant to the Act, the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization ("SRO"), and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will

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<sup>81</sup> See FINRA Response II at p.6. OTC Markets believed "NMS-type rules are harmful when applied to smaller companies." See OTC Markets Letter I at pp.1-2.

<sup>82</sup> See FINRA Response II at p.6. As noted above, Knight requested that the Commission examine the impact on trading, clearing (e.g., the operational complexity of clearing increased volumes of smaller trades in non-DTC eligible securities), related costs, locked markets, access fees, trading efficiency and market participant behavior under the proposed reduced tier sizes. See text accompanying note 42 *supra*.

<sup>83</sup> See OTC Markets Letter III.

<sup>84</sup> See OTC Markets Letter III at p.5.

<sup>85</sup> See OTC Markets Letter III at p.7.

<sup>86</sup> See OTC Markets Letter III at p.8.

<sup>87</sup> See OTC Markets Letter III at pp.2-3.

<sup>88</sup> 15 U.S.C. 78c(f).

promote efficiency, competition, and capital formation.<sup>89</sup> OTC Markets believed that FINRA’s proposed revisions potentially could have various dynamic effects on the OTC market.<sup>90</sup> OTC Markets stated that it reviewed data relating to all trades in OTC equity securities that occurred on October 27, 2011, with respect to share volume, dollar volume and number of trades in relation to the existing and proposed tier sizes.<sup>91</sup> Based on its review, OTC Markets believed that the proposal would not significantly increase liquidity but would impose a direct cost on investors, particularly investors placing marketable orders.<sup>92</sup> OTC Markets believed that the proposed rule change would lead most market makers to reduce their quote sizes and display less liquidity.<sup>93</sup> OTC Markets further believed that an extensive decrease in displayed proprietary liquidity would “overwhelmingly offset the benefit of the increased number of customer limit orders displayed.”<sup>94</sup>

B. Comment Letter Received on the Order Instituting Proceedings

Following publication by the Commission of the Order Instituting Proceedings, the Commission received another comment letter from OTC Markets, which reiterated its prior statements and provided additional data for consideration.<sup>95</sup> OTC Markets contended that, as part of the proceedings, the Original Proposal should be evaluated in the context of Section 3(f)

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<sup>89</sup> See OTC Markets Letter III at pp.2-3.

<sup>90</sup> See OTC Markets Letter III at p.4.

<sup>91</sup> See OTC Markets Letter III at p.5. OTC Markets stated that it had selected October 27, 2011 for its review because that day had the highest trading volume of any day that month and, according to the commenter, presumably also had the highest amount of investor liquidity for that month.

<sup>92</sup> See OTC Markets Letter III at p.6.

<sup>93</sup> See id.

<sup>94</sup> See OTC Markets Letter III at p.7.

<sup>95</sup> See OTC Markets Letter IV, supra note 11.

of the Act.<sup>96</sup> OTC Market stated that the proposal would contravene the requirements of Section 15A(b)(6) of the Act<sup>97</sup> because of the potential negative impact on the operation of the OTC market.<sup>98</sup> OTC Markets also stated that the proposal would contravene Section 15A(b)(11) of the Act<sup>99</sup> because of the potential decrease in displayed liquidity at the inside price.<sup>100</sup> OTC Markets submitted a DVD containing data for the month of October 2011 and noted that its data would be available to others who want to conduct a similar analysis.<sup>101</sup> Finally, OTC Markets reiterated its request that FINRA or the Commission provide additional data for a panel of independent academics to evaluate the appropriate tier size levels for OTC equity securities.<sup>102</sup>

C. Comment Letters Received on Amendment No. 1

Following the publication by the Commission of Amendment No. 1, the Commission received two more comment letters from Knight and OTC Markets, respectively.<sup>103</sup> As noted above, these commenters previously raised concerns relating to the portion of the Original Proposal that would revise the minimum quotation size requirements.<sup>104</sup> In providing comments on the proposal, as amended, Knight stated that “the changes FINRA made to the tier sizes address many of the points made in the comment letters. More specifically, FINRA’s revised proposal appears to strike an appropriate balance between displayed liquidity from retail limit

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<sup>96</sup> See OTC Markets Letter IV at p.2. See text accompanying note 88 supra for a description of Section 3(f) of the Exchange Act.

<sup>97</sup> 15 U.S.C. 78o-3(b)(6).

<sup>98</sup> See OTC Markets Letter IV at p.2.

<sup>99</sup> 15 U.S.C. 78o-3(b)(11).

<sup>100</sup> Id.

<sup>101</sup> See OTC Markets Letter IV at p.3.

<sup>102</sup> See OTC Markets Letter IV at p.4.

<sup>103</sup> See supra note 13.

<sup>104</sup> See, e.g., OTC Markets Letter I, Knight Letter I, OTC Markets Letter II, OTC Markets Letter III, and Knight Letter II.

orders and a tier size requirement for market makers.”<sup>105</sup> Knight also indicated support for FINRA’s proposed pilot program so that the impact of the changes to the Rule could be evaluated. Knight, however, suggested that the proposed one-year length of the pilot was too long and that a three- or four-month period would be sufficient to gather the necessary data for the analysis.<sup>106</sup> Finally, Knight noted that the recent Jumpstart Our Business Startups Act (“JOBS Act”), which requires the Commission to conduct a study and provide a report to Congress on the impact of changes to the minimum tick size requirements in light of decimalization, likely would have some relationship to FINRA’s proposed rule change.<sup>107</sup> Knight suggested that the Commission not approve FINRA’s proposal until the Commission completed the required JOBS Act study on tick sizes.<sup>108</sup> OTC Markets, who submitted four prior letters, stated that the amended proposal “improves on some facets of the original Proposed Rule, however the Amended Proposed Rule does not go far enough to protect liquidity and reduce volatility in the OTC market.”<sup>109</sup> OTC Markets also pointed to the recently enacted JOBS Act, and recommended that the new law’s required study should be combined with a study of the

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<sup>105</sup> See Knight Letter III at p.2.

<sup>106</sup> See id.

<sup>107</sup> See Knight Letter III at pp.2-3.

<sup>108</sup> See Knight Letter III at p.3. See 15 U.S.C. 78l-1(c)(6)(A) (“The Commission shall conduct a study examining the transition to trading and quoting securities in one penny increments, also known as decimalization. The study shall examine the impact that decimalization has had on the number of initial public offerings since its implementation relative to the period before its implementation. The study shall also examine the impact that this change has had on liquidity for small and middle capitalization company securities and whether there is sufficient economic incentive to support trading operations in these securities in penny increments. Not later than 90 days after the date of enactment of this paragraph, the Commission shall submit to Congress a report on the findings of the study.”).

<sup>109</sup> See OTC Markets Letter V at p.7.

potential effects of FINRA's proposal.<sup>110</sup> OTC Markets further suggested that it would not be appropriate to introduce the proposed pilot program until such study was completed.<sup>111</sup> OTC Markets stated that, without further study, the amended proposal's potential risks would outweigh its potential benefits, and that the length and breadth of the proposed pilot would pose unwarranted risk to the OTC equity market.<sup>112</sup> In addition to recommending that the Commission first conduct a study on liquidity and volatility using currently available data before approving the pilot program, OTC Markets suggested that FINRA remove a prohibition on broker-dealer proprietary trading in a security at a price equal to or better than an unexecuted customer limit order and allow the two orders to trade in parity and in proportion to their displayed liquidity. OTC Markets posited that this change would incentivize proprietary liquidity and protect customer limit orders.

#### IV. Amendment No. 2

FINRA stated that its purpose in filing Amendment No. 2 was to address comments made by Knight and OTC Markets on the revised proposal, as set forth in Amendment No. 1; outline the steps FINRA intends to take to review and assess the effects of the amended Rule during the pilot period; and clarify certain issues raised in the Original Proposal and Amendment No. 1.<sup>113</sup> FINRA noted that it filed Amendment No. 1 to modify the proposed tiers in response to the comments received by the Commission and to propose that the revised Rule be implemented as a one-year pilot to allow FINRA and the Commission to assess its impact.<sup>114</sup> FINRA remarked

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<sup>110</sup> See OTC Markets Letter V at pp.1-2.

<sup>111</sup> See OTC Markets Letter V at p.2.

<sup>112</sup> See OTC Markets Letter V at pp.2-3.

<sup>113</sup> See Amendment No. 2, supra note 14.

<sup>114</sup> See infra note 150 for a description of the data FINRA has committed to provide on a monthly basis to the Commission.

that, although commenters had suggested reducing the proposed one-year length of the pilot, FINRA did not believe that a three- or four-month pilot period would provide sufficient time to gather data and to evaluate fully the impact of the proposed rule change. FINRA stated, however, that it would regularly monitor the results of the pilot and, if FINRA concluded that there had been a significant negative impact (including on liquidity) on the OTC market, FINRA would consider rescinding the pilot prior to the end of its one-year period.

FINRA also discussed the suggestion by Knight and OTC Markets that the Commission review minimum quotation sizes and minimum tick sizes for OTC equities concurrently, in light of the directive set forth in the JOBS Act that the Commission study the impact of decimalization. In responding to this suggestion, FINRA stated its view that the amendments to the Rule should not be delayed in light of the potential benefits of increased limit order display for the market and for investors. FINRA stated that, if minimum tick sizes were to change as a result of the JOBS Act study, it would consider whether additional revisions are necessary for OTC equity securities.

FINRA noted that it had worked closely with OTC liquidity providers, including Knight, in revising the Original Proposal to best achieve a balance that would facilitate both the goal of providing meaningful liquidity commitments by market makers and the display of competitively priced customer limit orders. With regard to Knight's concerns about the clearing costs that potentially could result if reduced quote sizes resulted in a more fragmented market, particularly for non-DTCC eligible securities, FINRA stated that it would monitor for this issue during the pilot period, although it believed that such securities accounted for a very small percentage of securities that would be subject to the Rule.



FINRA pointed out that OTC Markets took issue with the amended proposal because the commenter believed that it would harm markets by reducing displayed liquidity. According to FINRA, OTC Markets appeared to have formed its views based on an internal analysis of one day's trading activity and on a comparison of the existing and proposed tier sizes, with the assumption that market makers' quotations were always at the minimum quotation size. FINRA stated that this review and comparison were not a sufficient basis upon which to reasonably predict the impact on liquidity. FINRA disagreed with OTC Markets' view that FINRA had not studied how the revised tiers would affect overall liquidity. FINRA noted that it had conducted multiple analyses of relevant data. FINRA also noted that the pilot program would provide for the ability to compare and contrast data in the most effective manner. FINRA stated that, as part of the pilot, FINRA would review the impact of the pilot and would provide data to the Commission so that the Commission also could analyze the impact of the pilot. Further, FINRA suggested that other comments by OTC Markets were not germane to the consideration of the merits of the proposed rule change, including the suggestion that FINRA Rule 5320, which prohibits broker-dealers from trading ahead of customer limit orders, should be amended to allow market makers to trade in parity with their customers.

In addition, FINRA committed to provide the Commission with the data necessary to assess the impact of the revised tier sizes on the OTC equity market. In Amendment No. 2, FINRA specified the categories of data that it would provide to the Commission on a monthly basis, starting no later than 90 days after the start of the pilot, including price and volume information, execution data, and liquidity metrics and the time frame within which FINRA

would submit the data.<sup>115</sup> FINRA also committed to provide the Commission with an assessment addressing the impact of the pilot, the concerns raised by commenters, and the effectiveness of the pilot in achieving the desired results.

Further, in Amendment No. 2, FINRA clarified certain matters. FINRA pointed out that, when it stated in the Original Proposal that “only approximately 50% of customer limit orders in the sample met the current Rule’s thresholds and would have been eligible to be displayed,” FINRA was referring to a sample that covered only those securities that were priced between \$0.51 and \$1.00. In Amendment No. 2, FINRA described a more recent sampling based on 32 randomly selected trading days between May and December 2011. FINRA found that the number of customer limit orders at or above the minimum tier size increased under the proposed tier sizes from approximately 85% of customer limit orders at or above the minimum size that would be eligible for display to 96% of customer limit orders.<sup>116</sup> Finally, FINRA noted that the correct implementation date period will be no sooner than 120 days, and no later than 180 days, from the date of Commission approval of the proposed rule change.

## V. Discussion and Findings

After careful review of the proposed rule change, as modified by Amendment Nos. 1 and 2, as well as the comment letters and the FINRA response letters received on the proposal, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.

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<sup>115</sup> In Amendment No. 2, FINRA also committed to provide the data for five random days from each month for a one-year period prior to the operative date of the pilot.

<sup>116</sup> FINRA’s analysis included all limit orders reported to OATS as being received by a FINRA member, including those from other FINRA members. FINRA excluded all proprietary orders originated by a member from its calculations. See *infra* notes 133 and 134 and accompanying text for a description of the analysis conducted by the staff of the Commission’s Division of Risk, Strategy and Financial Innovation.

In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,<sup>117</sup> in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. In addition, the Commission finds that the proposed rule change is consistent with Section 15A(b)(11), in that it includes provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied.<sup>118</sup>

The Commission preliminarily believes that the proposed rule change, by adjusting the minimum quotation size requirements of Rule 6433, should help facilitate the display of more customer limit orders for OTC equity securities priced \$0.20 and above than exists under the current Rule. The Commission notes that the benefits to investors of Rule 6460, which mandates the display of customer limit orders for OTC equity securities when that rule's conditions are met, are reduced if the minimum quotation requirements for OTC equity securities under Rule 6433 are set too high. The Commission preliminarily believes that incorporating a greater number of customer limit orders in quotes could improve the prices at which these customer orders are executed.

In addition, lowering the minimum quotation size requirements for OTC equity securities priced \$0.20 and above could foster greater liquidity for these securities because broker-dealers that currently do not make markets in some or all OTC equity securities could be incentivized to become market makers in these securities. The current minimum quotation size requirements may impede some broker-dealers from committing resources to certain OTC equity securities

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<sup>117</sup> 15 U.S.C. 78o-3(b)(6).

<sup>118</sup> 15 U.S.C. 78o-3(b)(11).

because they may consider the dollar value commitment inherent in the Rule's current thresholds to be too high. Lower minimum quotation size thresholds for certain OTC equity securities may prompt some broker-dealers to become market makers in OTC equity securities because, for securities quoted at \$0.20 and above, the minimum quotation size - and thus the minimum dollar value commitment to the security - would be reduced under the amended Rule.

If this were to occur, the increased competition from both market makers and customer limit orders could narrow spreads and increase liquidity in the market for OTC equity securities, to the benefit of investors, liquidity providers and the OTC marketplace generally. The Commission recognizes, however, that the actual broader impact of FINRA's proposed rule change on the market for OTC equity securities may not be known, and that the views of some commenters differ. Accordingly, the Commission believes that it is important that FINRA has proposed to implement the revised tier sizes as a one-year pilot program, and to provide the Commission with data to allow Commission staff to evaluate the actual impact of these changes on the OTC market, as well as to perform its own assessment thereof.

Further, the proposal would reduce from nine to six the number of price and size thresholds contained in the Rule. The Commission also notes that the proposal is designed to expand the scope of the Rule to cover quotations that are displayed on an inter-dealer quotation system by ATSS and by non-market making members representing customer trading interest. Expanding the scope of the Rule should help ensure that minimum quotation sizes are observed consistently by all FINRA members displaying quotations on an inter-dealer quotation system, whether those quotations are submitted by an OTC market maker or by an ATS.

As noted above, the Commission received ten comment letters from four separate commenters in response to the proposed rule change, as amended.<sup>119</sup> Two commenters supported the proposed rule.<sup>120</sup> Two other commenters, while generally supportive of the goal of enhancing limit order display, questioned the need to revise the Rule's current minimum quotation size requirements.<sup>121</sup> In their various letters, Knight and OTC Markets raised several main issues regarding both the Original Proposal and Amendment No. 1. Specifically, these commenters stated that the proposal: (1) was based on a flawed and/or insufficient data analysis and should be subject to further study; (2) would cause lower liquidity and greater volatility for OTC equity securities; (3) should operate as a pilot program; and (4) would not promote efficiency, competition or capital formation.<sup>122</sup> OTC Markets also disputed whether the proposed rule change is consistent with Sections 15A(b)(6) and 15A(b)(11) of the Act.<sup>123</sup>

In its review of the proposal, the Commission has carefully considered the issues and concerns raised by these commenters and, as discussed below, has evaluated those issues and concerns in light of the mandate of Section 19(b)(2) of the Act that the Commission shall approve a proposed rule change if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to a self-regulatory organization.

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<sup>119</sup> See supra notes 6, 11 and 13.

<sup>120</sup> See Shatto Letter and Hamlet Letter, supra note 6.

<sup>121</sup> Specifically, Knight stated its support for the goal of making additional limit orders eligible under Rule 6460 for display, whereas OTC Markets stated its support for expanding Rule 6433 to include all quotations or orders published in inter-dealer quotation systems. See Knight Letter I at p.1 and OTC Markets Letter I at p.1.

<sup>122</sup> See Section 3(f) of the Act, 15 U.S.C. 78c(f).

<sup>123</sup> 15 U.S.C. 78o-3(b)(6) and 15 U.S.C. 78o-3(b)(11).

A. Whether the Proposed Rule Change is Consistent with Sections 15A(b)(6) and 15A(b)(11) of the Act

FINRA is a registered national securities association that is composed of brokers and dealers that are registered with the Commission under Section 15(a) of the Act. Among other things, FINRA regulates its members with respect to their activities in OTC equity securities pursuant to authority granted to it by Congress under Section 15A of the Act.<sup>124</sup> FINRA's mandate under Section 15A(b)(6) is to assure that its rules, among other things, are designed to “prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers . . . .”<sup>125</sup> Pursuant to Section 15A(b)(11) of the Act, FINRA is authorized to adopt rules applicable to its members “governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied.”<sup>126</sup> Such rules must be “designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.”

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<sup>124</sup> 15 U.S.C. 78o-3.

<sup>125</sup> 15 U.S.C. 78o-3(b)(6).

<sup>126</sup> 15 U.S.C. 78o-3(b)(11).

OTC Markets asserted that FINRA's proposal contravenes Section 15A(b)(6) of the Act and disregards Section 15A(b)(11) of the Act.<sup>127</sup> The Commission believes that FINRA has authority under Sections 15A(b)(6) and 15A(b)(11) to establish rules governing the minimum quotation size requirements for its members when they enter quotations for OTC equity securities in an inter-dealer quotation system and to revise those rules, as necessary or appropriate. The proposed rule change, as amended, would revise the minimum quotation size requirements for broker-dealers that quote OTC equity securities in an inter-dealer quotation system. These minimum quotation size requirements impact not only the size of the quotes that broker-dealers must honor, but also the minimum size of customer limit orders that may have a right to be displayed. In the Commission's view, FINRA's proposed revisions are designed to protect investors by revising the Rule's tier thresholds such that a larger percentage of customer limit orders are reflected in quotations for OTC equity securities, thereby potentially improving the prices at which customer limit orders will be executed, consistent with the protection of investors and the public interest. In addition, as noted above, lowering the minimum quotation size requirements could incent more broker-dealers to become market makers in OTC equity securities. Although further study will be required during the pilot period, if more broker-dealers become market makers in OTC equity securities, there could be a further narrowing of spreads and an increase in liquidity in the OTC market, to the benefit of investors, the public interest, and the perfection of a free and open market and a national market system. In addition, the Commission considers the proposed rule change to govern the form and content of quotations for OTC equity securities, consistent with Section 15A(b)(11) of the Act.

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<sup>127</sup> See OTC Markets Letter IV at p.2.

B. Whether FINRA’s Data Analysis Was Flawed

In several comment letters, OTC Markets claimed that FINRA’s analysis that the Original Proposal would result in an increased display of customer limit orders was flawed.<sup>128</sup> OTC Markets stated that the reduction of minimum quote size requirements “has not been shown by FINRA to benefit investors and has a significant risk that it will degrade market quality.”<sup>129</sup> OTC Markets claimed that FINRA’s analysis was inaccurate and misleading because FINRA did not segment the order data by market orders, marketable limit orders, limit orders that would have improved the spread of the best bid/offer, limit orders at the best bid/offer, and limit orders outside the best bid/offer.<sup>130</sup> OTC Markets also contended that FINRA failed to analyze the number of executions against limit orders and the number of executions involving a broker-dealer trading as principal.<sup>131</sup> Both OTC Markets and Knight urged the Commission to conduct its own analysis of FINRA’s proposal.<sup>132</sup>

In response to these comments, the staff of the Commission’s Division of Risk, Strategy and Financial Innovation (“RSFI”) undertook an empirical analysis relating to the potential effects of the proposal, which was intended to supplement FINRA’s analysis, and performed a modification of the analysis that FINRA discussed in the Original Proposal, using the first five

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<sup>128</sup> See OTC Markets Letter I at p.2; OTC Markets Letter II; and OTC Markets Letter III at pp.7-8.

<sup>129</sup> See OTC Markets Letter I at p.1.

<sup>130</sup> See OTC Markets Letter III at p.5.

<sup>131</sup> Id.

<sup>132</sup> See, e.g., OTC Markets Letter I at pp.3-4; OTC Markets Letter II; and Knight Letter I at p.2. OTC Markets provided data relating to quotes and trades in OTC equity securities that occurred in October 2011, which the commenter provided for the benefit of Commission staff and others to use in conjunction with a review of FINRA’s proposed rule change.



trading days of November 2011.<sup>133</sup> The RSFI staff found that, for customer orders with limit prices between \$0.51 and \$1.00, displayable orders would increase from 47.5% to 92.6% under the revisions to the tier sizes contained in the Original Proposal. The RSFI staff stated that this finding was consistent with the results reported by FINRA for that particular tier size in the Original Proposal. Applying the revised tier sizes in Amendment No. 1, the RSFI staff discerned that the percentage of displayable orders for the same tier threshold noted above would increase from 47.5% to 73.8%. In addition, the RSFI staff examined customer orders, regardless of price, and found that the percentage displayed under the current tier structure is 92.5% and would increase to 97.5% under Amendment No. 1. As described in detail in the RSFI Memorandum, the RSFI staff's analysis found that the greatest increase in transparency likely would occur for securities priced between \$0.10 and \$1.00.<sup>134</sup> In addition, the RSFI staff estimated that the proposed tier sizes included in Amendment No. 1 might reduce the transaction costs for executed limit orders that would be newly visible by an upper bound of \$7,173 per day, or 1.75% of dollar volume for these limit order executions.

The Commission believes that the RSFI Staff Analysis supports FINRA's rationale for the proposed rule change, as amended, in that there would be a material increase in the number of customer limit orders to be displayed under the revisions to Rule 6433. OTC Markets claimed

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<sup>133</sup> See Memorandum from the Division of Risk, Strategy and Financial Innovation, dated June 1, 2012 ("RSFI Memorandum"). A copy of the RSFI Memorandum is located in the Commission's public file for SR-FINRA-2011-058 at <http://www.sec.gov/comments/sr-finra-2011-058/finra2011058.shtml>.

<sup>134</sup> In Amendment No. 2, FINRA stated that it reviewed data for 32 randomly-selected days between May and December 2011 and found that the number of customer limit orders displayed would increase from approximately 85% under the Rule's current tiers to 96% under the Rule's revised tiers. As noted above, the RSFI staff concluded that the number of customer limit orders displayed would increase from 92.5% to 97.5%. The RSFI Staff Analysis notes that the RSFI staff considered only new customer orders; routed orders were duplicative and therefore were removed from the sample. See RSFI Staff Analysis, supra note 133.

that FINRA’s analysis failed to account for the fact that FINRA’s Rule 6460 requires a market maker that receives customer limit orders to aggregate those orders for purposes of the limit order display rule.<sup>135</sup> In response, FINRA stated that many of the 10,000 OTC equity securities quoted on inter-dealer quotation systems trade infrequently and at widely varying volume levels each day.<sup>136</sup> FINRA noted that, based on its review of quotation and trade data for OTC equity securities over a two week period, less than three percent of OTC equity securities with a priced quotation trade 100 or more times per day.<sup>137</sup>

C. Whether the Proposal Would Result in an Impact on Liquidity and Volatility

Knight argued that FINRA had not adequately demonstrated that the proposed revisions to the minimum quotation size requirements for OTC equity securities would benefit investors and instead countered that the proposal would degrade the quality of the market for these securities.<sup>138</sup> Knight also stated that the proposal could impact market liquidity and increase costs to market makers, which could result in market makers’ departure from the OTC market.<sup>139</sup> Both Knight and OTC Markets urged the Commission to undertake an economic analysis of the anticipated effects of the proposal as part of its consideration of the proposed rule change and

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<sup>135</sup> See OTC Markets Letter I at pp.2-3. See also Regulatory Notice 10-42 (September 2010) (“firms must aggregate same-priced customer limit orders in OTC Equity Securities . . .”) (citing Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (adopting Rule 11Ac1-4 under the Act, which requires the display of customer limit orders priced better than a specialist’s or OTC market maker’s quote. Rule 11Ac1-4 was subsequently redesignated as Rule 604 under Regulation NMS) (“Order Handling Rules Release”)).

<sup>136</sup> See FINRA Response I at p.3.

<sup>137</sup> Id.

<sup>138</sup> See Knight Letter I at p.1.

<sup>139</sup> See Knight Letter I at p.2.

suggested that, if the Commission decided to move forward with the proposal, it should consider approving the proposed changes to the Rule's tier structure on a pilot basis.

The Commission recognizes that FINRA's proposal involves a balancing of potentially competing forces. Following the May 2011 implementation of Rule 6460, which requires the display of certain customer limit orders in OTC equity securities, FINRA reviewed OATS data and concluded that, for OTC equity securities priced between \$0.51 and \$0.9999 per share, a significant percentage of customer limit orders were not eligible for display under the Rule.<sup>140</sup> As the Commission noted when it approved FINRA's proposed rule change to adopt Rule 6460, "FINRA's limit order display proposal marks a positive step in efforts to improve the transparency of OTC Equity Securities and the handling of customer limit orders in this market sector."<sup>141</sup> FINRA's proposal to amend Rule 6433 in a manner that would result in a greater number of customer limit orders being displayed could further increase transparency, and promote competition and narrow spreads, in the OTC market. The Commission notes that OTC equity securities historically have been subject to Commission action in part because they lack transparency.<sup>142</sup>

On the other hand, Knight and OTC Markets expressed concern that FINRA's proposal would lead to a diminution of liquidity and efficiency for OTC equity securities and potentially

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<sup>140</sup> See Notice at p.65308 and Amendment No. 2 at p.7.

<sup>141</sup> See NMS-Principled Rules Approval Order, *supra* note 4.

<sup>142</sup> See generally Securities Exchange Act Release No. 64612 (June 7, 2011) (suspension of trading in common stock of 17 companies trading in OTC markets); Securities Exchange Act Release No. 66980 (May 14, 2012) (suspension of trading in common stock of 379 companies quoted on OTC Link). See also Catton v. Defense Technology Systems, Inc., 457 F. Supp. 2d 374 (S.D.N.Y. 2006); S.E.C. v. Simmons, 2008 WL 7935266 (M.D.Fla. Apr 25, 2008); SEC v. Irwin Boock, Stanton B.J. DeFreitas, Nicolette D. Loisel, Roger L. Shoss, and Jason C. Wong, Birte Boock, and 1621566 Ontario, Inc., 2011 WL 3792819 (S.D.N.Y. August 25, 2011), reconsideration denied, 2011 WL 5417106 (S.D.N.Y. November 9, 2011).

exacerbate volatility in this market segment.<sup>143</sup> Both commenters believed that market makers would reduce their quoted sizes to conform to the proposed lower tier sizes.<sup>144</sup> While OTC Markets did not dispute that FINRA’s proposal would increase the number of displayed customer limit orders, it believed that a “decrease in displayed proprietary liquidity will overwhelmingly offset the benefit of the increased number of customer limit orders displayed.”<sup>145</sup>

Although the Commission recognizes these commenters’ concerns regarding the potential negative impact of FINRA’s proposal on the OTC market,<sup>146</sup> the Commission notes that they offered limited data supporting their claims.<sup>147</sup> In addition, as discussed above, as well as increasing the number of customer limit orders eligible for display and the potential for better executions, arguments can be made that FINRA’s proposal will benefit the OTC market by facilitating market making activity, reducing spreads and increasing liquidity. While market

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<sup>143</sup> See OTC Markets Letter 1 at p.3; OTC Markets Letter III at pp.4-6; OTC Markets Letter IV at pp.2-3; OTC Markets Letter V at p.2; and Knight Letter I at pp.1-2.

<sup>144</sup> See OTC Markets Letter 1 at p.3; OTC Markets Letter III at p.6; and Knight Letter I at pp.1-2.

<sup>145</sup> See OTC Markets Letter III at p.7.

<sup>146</sup> OTC Markets stated that FINRA, in its amended proposal, made a minimal effort to protect proprietary liquidity and to research the amended proposal’s “probable negative effect on proprietary liquidity.” See OTC Markets Letter V at p.6.

<sup>147</sup> OTC Markets’ commented that it analyzed the impact of the proposal with respect to share volume, dollar volume and number of trades, based on trade data for October 27, 2011. See OTC Markets Letter III at pp.5-7. According to OTC Markets, its analysis suggested that the proposed rule would not significantly increase liquidity but would impose a direct cost on investors, particularly investors placing marketable orders. The Commission notes that OTC Markets’ analysis was based on the tier sizes set forth in the Original Proposal. See Section V.D. below for a reference to OTC Markets’ analysis of the impact of the revisions to the Rule proposed in Amendment No. 1. The Commission believes that FINRA’s proposed minimum quotation size requirements and the operation of those new quote size requirements as a pilot program, as set forth in Amendment No. 1, are designed to address the concerns of this commenter and could mitigate potential adverse impacts the proposal could have on dealers and investors.

makers may tend to reduce their quoted size to the minimum required by FINRA's rules,<sup>148</sup> the reduction in capital commitment per security could allow them to make markets in a wider range of OTC equity securities. This could enhance market maker competition and - along with competition from customer limit orders - result in a reduction in spreads in the OTC market. While the displayed size at the tighter inside price may decline, the overall impact on liquidity - looking at the cumulative depth available - may be neutral or positive. If this were the case, the impact of FINRA's proposal on volatility could be neutral or positive as well.

Because of the uncertainty of the actual impact of FINRA's proposal on market maker behavior, however, the Commission believes that it is necessary to conduct a meaningful review of data collected during the pilot period to credibly assess this aspect of the proposed rule change.<sup>149</sup> The Commission notes that, in Amendment No. 2, FINRA committed to provide the Commission with specified data to assist the Commission in its assessment of the impact of the pilot on the OTC market.<sup>150</sup> Further, FINRA committed to provide, at least 60 days before the

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<sup>148</sup> The Commission also notes that the proposed rule change does not mandate that market makers in OTC equity securities conform to the new tier sizes. In fact, market makers would continue to have the ability to quote at sizes greater than the new minimum tier sizes. As the Commission previously found, when OTC market makers were required to display only 100 shares regardless of the price of the shares, the trading practices of active market makers were to display higher liquidity than the minimum. See Securities Exchange Act Release No. 32570 (July 1, 1993), 58 FR 36725 (July 8, 1993) (Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Quotation Size Requirements for Market Makers in OTC Equity Securities).

<sup>149</sup> With respect to the comment from Knight that the proposed rule change would have an adverse impact on both dealers and investors, the Commission preliminarily believes that the revised proposal, as described in Amendment No. 1, would facilitate the display of additional customer orders while still requiring a reasonable commitment of liquidity from market makers. See Knight Letter I at pp.1-2.

<sup>150</sup> In Amendment No. 2, FINRA committed to provide the following data to the Commission, on a monthly basis, to allow its staff to evaluate the impact of the pilot: the price of the first trade of each trading day executed at or after 9:30:00 a.m., based on execution time; the price of the last trade of each trading day executed at or before 4:00:00 p.m., based on execution time; daily share volume; daily dollar volume; number

conclusion of the pilot, its own assessment of the impact of the pilot, addressing the concerns raised by commenters regarding the efficacy of the pilot in achieving its intended effects. Moreover, FINRA committed to revisit the pilot program during its pendency should an analysis of the data show degradation in liquidity and other factors indicating that the revisions to the Rule are having an adverse effect on OTC equity securities. Finally, the Commission notes that FINRA's adjustment of the minimum quotation sizes in Amendment No. 1 was designed to address some of the concerns expressed by commenters with respect to the impact of the Original Proposal on the quality of the OTC market.<sup>151</sup>

Knight stated that the Commission should "properly evaluate the costs and benefits" associated with FINRA's proposal and other SRO proposed rule changes.<sup>152</sup> Similarly, OTC Markets requested that the Commission conduct a "thorough economic analysis" of the effects of

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of limit orders from customers and in total; percentage of day the size of the BBO (i.e., best bid and offer on FINRA's OTCBB facility and OTC Link) equals minimum quote size; number of market makers actively quoting; number of executions from a limit order and number of limit orders at the BBO or better by tier size from a customer and in total; time-weighted quoted spread; effective spread; time-weighted quoted depth (number of shares) at the inside; and time-weighted quoted depth (dollar value of shares) at the inside.

<sup>151</sup> OTC Markets suggested that FINRA bolster liquidity in the OTC equity market by allowing a broker-dealer that displays liquidity in an OTC equity security and subsequently receives a customer limit order in that security at a price equal to the firm's proprietary quote to "trade in parity" with its customer. See OTC Markets Letter V at p.6. The Commission notes that this suggestion would require FINRA to file a proposed rule change to amend FINRA Rule 5320. FINRA Rule 5320 generally prohibits a member from trading for its own account in an equity security, including OTC equity securities, at a price that is equal to or better than an unexecuted customer limit order in that security, unless the member immediately thereafter executes the customer limit order at the price at which it traded for its own account or better. Because an amendment to Rule 5320 is not a matter currently before the Commission, the Commission is not taking any action on such a proposal at this time.

<sup>152</sup> See Knight Letter II at p.2.

FINRA's proposal on the OTC market.<sup>153</sup> As noted above, RSFI staff conducted an empirical analysis relating to the potential effects of FINRA's proposal on the display of customer limit orders and the transaction costs for executed customer limit orders.<sup>154</sup> In addition, FINRA has committed to provide the Commission with data necessary to evaluate the impact of the pilot on the OTC market, as well as with its own assessment thereof. The Commission notes that interested persons are welcome to submit additional comments and empirical evidence during the pilot period with respect to, among other things, the operation of the revised minimum quotation size requirements, their effectiveness in achieving their intended goals, and the costs associated therewith. The Commission will take such comments, as well as empirical evidence, submitted by interested persons during the pilot period into account in considering whether to approve, in accordance with Section 19(b) of the Act, any FINRA proposed rule change that would make the pilot permanent or would make any other changes to the pilot.

#### D. Pilot Program

In letters commenting on the Original Proposal, Knight and OTC Markets suggested that FINRA implement its revised minimum quotation requirements as a pilot program.<sup>155</sup> OTC Markets, for example, would "support any action by the Commission to promote a pilot program to better determine the effects of a change in tier sizes in the OTC Market."<sup>156</sup>

In response to these and other suggestions of commenters, FINRA submitted Amendment No. 1 to revise the price and size tiers in comparison to the Original Proposal and committed to operate the revised Rule as a one-year pilot program. In responding to the Commission's notice

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<sup>153</sup> See OTC Markets Letter V at p.7.

<sup>154</sup> See supra notes 133 and 134 and accompanying text.

<sup>155</sup> See Knight Letter I at p.2 and OTC Markets Letter IV at p.3.

<sup>156</sup> See OTC Markets Letter IV at p.3.

of Amendment No. 1,<sup>157</sup> Knight offered its support for a pilot program so that the impact of the revised Rule could be evaluated.<sup>158</sup> Knight, however, expressed the view that a three- to four-month pilot program would suffice for FINRA to gather the necessary data for its analysis. Knight remarked that the potential impact of the newly-enacted JOBS Act must be considered in connection with the proposed revisions to Rule 6433. Knight pointed to the provision of the JOBS Act that requires the Commission to study the impact of decimalization, including its impact on small and mid-sized issuers' securities. Knight urged that the Commission's study of minimum tick size requirements and FINRA's proposed minimum tier size requirements for OTC equity securities be evaluated together.

OTC Markets also submitted a comment letter in response to the Commission's notice of Amendment No. 1.<sup>159</sup> OTC Markets criticized the revised proposal in Amendment No. 1 because, in OTC Markets' view, FINRA did not include a substantial analysis to support its latest proposed tier thresholds. OTC Markets stated that it conducted an internal study that indicated that, under the proposal set forth in Amendment No. 1, approximately 51% of the securities with priced quotes on its OTC Link platform would experience considerable reductions in liquidity. OTC Markets remarked that the Commission's impending tick size study could incorporate an analysis of the effects of the amended proposed rule change.

The Commission notes that initially both Knight and OTC Markets suggested that FINRA adopt the proposal on a pilot basis. Knight continues to favor a pilot program, albeit for a period of time shorter than the one year proposed by FINRA. OTC Markets, however, states that FINRA and the Commission first should seek academics and economists to conduct a study

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<sup>157</sup> See supra note 12 (Notice of Amendment No. 1).

<sup>158</sup> See Knight Letter II at p.2.

<sup>159</sup> See OTC Markets Letter V.



of the proposal and then consider a three-month pilot program. As discussed above, the Commission preliminarily believes that FINRA's proposed rule change should help facilitate the display of more customer limit orders, and thereby increase transparency, promote competition, and potentially narrow spreads and provide better executions in the OTC market. In addition, by reducing the required capital commitment of market makers per security, arguments can be made that FINRA's proposal may enhance market making competition and further reduce spreads. The Commission recognizes, however, that Knight and OTC Markets have deep concerns about the impact of FINRA's proposal on the quality of the OTC market. Although both FINRA and Commission staff analyses have confirmed that FINRA's proposal should increase the number of customer limit orders eligible for display, the Commission believes that the uncertainty regarding the impact of FINRA's proposal on market maker behavior warrants its implementation on a pilot basis. During the pilot period, FINRA will submit the data and analysis described in Amendment No. 2, which will afford the Commission an opportunity to assess the proposal's impact on, among other things, the liquidity of OTC equity securities. Although Knight and OTC Markets were of the view that a one-year pilot period is too long, the Commission believes that a one-year pilot is reasonable to allow the Commission to meaningfully and reliably evaluate its impact of FINRA's proposal on the market for OTC equity securities. In addition, the Commission notes that, in Amendment No. 2, FINRA committed to monitor the impact of the pilot and, if it concludes that the revised tier sizes have a significant negative impact on the OTC market, including on liquidity, to consider rescinding the pilot prior to its expiration.

Finally, both Knight and OTC Markets urged that the Commission assess the impact of the proposed rule change in connection with the tick size study mandated by the JOBS Act.<sup>160</sup>

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<sup>160</sup> See supra note 108.

Pursuant to the JOBS Act, the Commission is required, among other things, to study the impact that decimalization has had on the number of initial public offerings, as well as on liquidity for small and middle capitalization company securities. The Commission notes that FINRA’s proposal addresses the minimum quotation size requirements for OTC equity securities, and not the pricing increments at which these securities trade. The Commission recognizes that both minimum quotation size requirements and minimum pricing increments can impact liquidity, spreads and other core aspects of the OTC market in similar ways. The Commission believes, however, that it is appropriate to approve FINRA’s proposal on a pilot basis to assess its impact on the market for OTC equity securities.

E. Efficiency, Competition, and Capital Formation

Knight and OTC Markets stated that FINRA failed to consider the proposed rule change in light of Section 3(f) of the Act.<sup>161</sup> Section 3(f) requires that whenever, pursuant to the Act, the Commission is engaged in rulemaking, or in the review of an SRO rule, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As discussed above, the Commission preliminarily believes that the proposed rule change could promote efficiency<sup>162</sup> by increasing the transparency of customer limit orders<sup>163</sup> and

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<sup>161</sup> 15 U.S.C. 78c(f). See also OTC Markets Letter III at p.2; Knight Letter II at p.1 (incorporating views of OTC Markets Letter III); OTC Markets Letter IV at p.2; OTC Markets Letter V at p.5.

<sup>162</sup> Knight expressed concern that the proposal “could have far-reaching effects on the liquidity and efficiency of the OTC market . . . .” See Knight Letter I at p.2. OTC Markets expressed concern regarding the “potential negative effects on displayed liquidity and costs related to the execution of marketable orders.” See OTC Markets Letter IV at p.2.

potentially narrowing spreads and providing better executions.<sup>164</sup> Currently, better-priced customer limit orders need not be displayed if the size of those orders is below the minimum quotation size for the pertinent OTC equity security.<sup>165</sup> Thus, customers who place such limit orders in a size smaller than the applicable minimum quotation size would not be entitled to have their orders displayed.

The Commission preliminarily believes that, by increasing the display of customer limit orders, spreads in OTC equity securities could be narrowed, allowing market participants to trade at better prices.<sup>166</sup> In addition, although further consideration will be given to the actual impact of the proposed rule change on efficiency during the pilot period, FINRA's proposal – by reducing the required per security capital commitment by market makers<sup>167</sup> – could incent market makers to make markets in a wider range of OTC equity securities, potentially reducing spreads and increasing liquidity.

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<sup>163</sup> See NMS-Principled Rules Approval Order, supra note 4 at 37494 (“The Commission believes that extending limit order display requirements to OTC Equity Securities is reasonably designed to increase transparency in the market for OTC Equity Securities.”)

<sup>164</sup> See id. (“As it has previously stated, the Commission believes that limit orders are a valuable component of price discovery, and that uniformly requiring display of such orders will encourage tighter, deeper, and more efficient markets.”); see also Order Handling Rules Release, supra note 135 at 48294 (“The display of limit orders can be expected to narrow the bid-ask spread when this buying and selling interest is priced better than publicly disclosed prices.”).

<sup>165</sup> Customer limit orders priced at the market maker's quote also need not be displayed depending on whether the size of the customer limit order is de minimus and whether the market maker's quote is at the best bid or offer. See FINRA Rule 6460.

<sup>166</sup> See NMS-Principled Rules Approval Order, supra note 4 at 37494. See also generally Michael J. Barclay, et al., Effects of Market Reform on the Trading Costs and Depths of Nasdaq Stocks, *Journal of Finance* (May 6, 2003); Foucault, et al., Working Paper: Limit Order Book as a Market for Liquidity (May 30, 2001) (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=269908](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=269908)).

<sup>167</sup> See NMS-Principled Rules Approval Order (“The Commission notes that FINRA's limit order display proposal acknowledges the role that market makers traditionally have played in providing price discovery and liquidity to the OTC Equity Securities market.”).

The Commission further preliminarily believes that the proposed rule could enhance competition by increasing the number of customer limit orders that are displayed to the market, thereby increasing quote competition and the likelihood of price improvement for OTC equity securities.<sup>168</sup> The Commission acknowledges that the narrowing of spreads that result from the increased display of customer limit orders could result in decreased profits for market makers, thus making them less willing to provide liquidity to the marketplace.<sup>169</sup> However, as discussed above, the decrease in the minimum quotation size requirements also could result in increased quoting by market makers because of the reduced capital commitment required per security, and thus increase competition among market makers. As with the proposal's effects on efficiency, the Commission will give further consideration to the actual impact of the proposed rule change on competition during the pilot period.

The Commission also has considered whether the proposed rule change would promote capital formation.<sup>170</sup> The Commission notes that increased display of customer limit orders could result in narrower spreads which, in turn, could attract more investors to the marketplace. Increased investor activity could result in more efficient pricing and increased liquidity.

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<sup>168</sup> See *id.* See also Order Handling Rules Release, *supra* note 135 at 48294 (“The uniform display of limit orders also will lead to increased quote-based competition. Market makers will not only be competing amongst themselves, but also against customer limit orders represented in the quote.”). See also generally Michael J. Barclay, et al., Effects of Market Reform on the Trading Costs and Depths of Nasdaq Stocks, *Journal of Finance* (May 6, 2003); Jeffrey Smith, The Effects of Order Handling Rules and 16ths on Nasdaq: a Cross-sectional Analysis, NASD Working Paper 98-02 (October 29, 1998).

<sup>169</sup> See Amendment No. 2, *supra* note 14 at p.8. See also Knight Letter I at p.2 (“we do have concerns that any increase in costs to market making liquidity providers may further result in additional departures of market makers . . . .”); OTC Markets Letter III at p.6 (“Smaller tier sizes also have the effect of reducing passive liquidity providers that create additional liquidity by competing at the inside price for investor executions, as the liquidity is based on a multiple of the inside size.”).

<sup>170</sup> See OTC Markets Letter III at p.4 (“tier sizes should be designed to create the optimum balance to maximize marketplace efficiency and capital formation”).

Efficient pricing and increased liquidity could make the OTC marketplace a more attractive venue for capital formation, benefiting small issuers.<sup>171</sup> However, if the revised tier sizes result in less activity by market makers, overall liquidity in the marketplace could decline. Such a decline could result in increased volatility and less efficient pricing for OTC equity securities. As a result, the OTC marketplace could become a less attractive venue for capital formation and thus negatively impact smaller issuers. The Commission preliminarily believes the overall impact of the proposal on the OTC marketplace will not be significantly negative or positive, but will monitor the impact of the revised tier sizes in connection with the pilot program.

#### VI. Accelerated Approval

The Commission finds goods cause, pursuant to Section 19(b)(2) of the Exchange Act,<sup>172</sup> for approving the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto, prior to the 30th day after publication of notice of the filing of Amendment No. 2 in the Federal Register. The proposed rule change, as amended, was informed by FINRA's consideration and incorporation of many suggestions made in comments to the Original Proposal, the Order Instituting Proceedings and Amendment No. 1. Amendment No. 2 reflects FINRA's efforts to adjust its proposal to better address commenters' concerns and allow the impact of its proposal to be studied on a pilot basis. The proposed rule change, as amended, will allow the Commission to further consider, during the pilot period, issues raised by commenters with respect to certain aspects of the proposal, and to benefit from actual experience with the revised tier sizes that are being approved today on a pilot basis. Such further consideration will allow the Commission to

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<sup>171</sup> See Amendment No. 1, supra note 12 at p.6, in which FINRA stated that "the improved display of customer limit orders resulting from the revised minimum quotation sizes will enhance the quality of published quotations for OTC Equity Securities and enhance competition and pricing efficiency in the market for OTC Equity Securities, which also should have a positive impact on capital formation."

<sup>172</sup> 15 U.S.C. 78s(b)(2).

consider whether modifications to the proposal are warranted prior to any decision to approve it on a permanent basis.

Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

## VII. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 2 to the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2011-058 on the subject line.

### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2011-058. This file number should be included on the subject line if e-mail is used.

To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in

accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2011-058, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

#### VIII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>173</sup> that the proposed rule change (SR-FINRA-2011-058), as modified by Amendment Nos. 1 and 2, be, and hereby is, approved on an accelerated basis as a one-year pilot.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>174</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>173</sup> 15 U.S.C. 78s(b)(2).

<sup>174</sup> 17 CFR 200.30-3(a)(12).