

FINANCIAL INFORMATION FORUM

December 2, 2021

By electronic mail to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 21-35: FINRA Requests Comment on Proposed Order Routing Disclosure Requirements for OTC Equity Securities and Potential Steps to Facilitate Investor Access to Current Order Routing Disclosures for NMS Securities

Dear Ms. Mitchell,

The Financial Information Forum (FIF)¹ appreciates the opportunity to comment on Regulatory Notice 21-35 (the Regulatory Notice) published by the Financial Industry Regulatory Authority (FINRA).² The Regulatory Notice solicits “comment on a proposal to require members to publish quarterly order routing disclosure reports for held orders in OTC Equity Securities.” “The proposed new quarterly reports would be similar to those required for NMS stocks” under Rule 606(a) of Regulation NMS adopted by the Securities and Exchange Commission (the Commission), “with certain modifications reflecting the different structure of the OTC market.” In the Regulatory Notice, “FINRA also requests input on possible steps to further facilitate investor access and understanding of current order routing disclosures for NMS securities.”³ In this letter, we refer to the proposed new quarterly reports for OTC Equity Securities as the “proposed OTC routing reports” or the “OTC routing reports”.

This comment letter does not express either support or opposition to the rule proposal as different FIF members have differing views about the advisability of the proposed routing disclosure reports. This comment letter is focused on achieving the most effective implementation of the new routing reports in the event that FINRA moves forward with this initiative.

¹ FIF (www.fif.com) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the securities industry across the order lifecycle. Our participants include broker-dealers, exchanges, back office service bureaus, and market data, regulatory reporting and other technology vendors in the securities industry. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

² FINRA Regulatory Notice 21-35 (October 6, 2021), available at <https://www.finra.org/sites/default/files/2021-10/Regulatory-Notice-21-35.pdf> (Regulatory Notice 21-35).

³ Regulatory Notice 21-35, p. 1.

In Section I of this comment letter we discuss the question of which entity should be reported when there are multiple levels of routing for an order. This is a fundamental issue that impacts many of the other issues raised by FINRA in the Regulatory Notice. In Section II of this comment letter we respond to the specific questions raised by FINRA in the Regulatory Notice.

I. Which entity should be reported

A fundamental question to consider for this type of report is the “venue” that should be reported. The Commission’s November 2018 Adopting Release titled “Disclosure of Order Handling Information” (the Rule 606 Amendments Adopting Release) amended Rules 600, 605 and 606 of the Commission’s Regulation NMS. The Rule 606 Amendments Adopting Release describes the purpose of Rule 606(a) as “providing enhanced transparency for financial inducements faced by broker-dealers when determining where to route held NMS stock order flow.”⁴

There are many scenarios where a customer-facing broker-dealer will route an OTC equity order to a second broker-dealer that is neither a market maker nor an alternative trading system. That second broker-dealer will then manage further routing and execution of the order. To understand the financial inducements faced by the customer-facing broker-dealer in this scenario, the relevant information is the payment received by the customer-facing broker-dealer from the second broker-dealer (or, as applicable, the payment made by the customer-facing broker-dealer to the second broker-dealer). Accordingly, to achieve the stated objective of Rule 606(a), as quoted above, it is important that the customer-facing broker-dealer report the second broker-dealer in this scenario.

If the customer-facing broker-dealer instead reports the venue to which the second broker-dealer further routes the customer’s order and the associated fee arrangement between the second broker-dealer and that downstream venue (referred to by industry members as “look-through reporting”), this obscures the financial inducements faced by the customer-facing broker-dealer. In particular, any payment for order flow made by the second broker-dealer to the customer-facing broker will not be disclosed. This is contrary to the stated objective of Rule 606, as quoted above.

The most significant problem with look-through reporting, as described above, is that it obscures the financial inducements faced by the broker-dealer providing the report, thereby negating the purpose for the report. The following are additional problems with look-through reporting:

- Look-through creates unnecessary complexity and confusion for the person reviewing the report because some of the data in the report does not reflect financial arrangements involving the customer-facing broker-dealer. While additional detail can be provided in footnotes, the integrity and comparability of the tabular data is compromised.
- Look-through for Rule 606(a) applies when an entity does not function as a “venue for execution”. Because there is often lack of clarity as to when an entity is functioning as a venue for execution, different broker-dealers take different interpretations as to when look-through applies. This leads to inconsistent reporting across reporting firms.

⁴ Exchange Act Release No. 84528 (Nov. 2, 2018), 83 FR 58338 (Nov. 19, 2018) (“Rule 606 Amendments Adopting Release”).

- Look-through requires a customer-facing broker-dealer to report on financial arrangements to which the customer-facing broker-dealer is not a party. As a general rule, if regulators require reporting about a financial arrangement, the regulators should require that this information be provided by the parties to the arrangement. It is generally problematic to require that a third-party report on financial arrangements involving two other parties because the third-party has limited ability to validate this data.
- Look-through added significantly to the initial implementation costs for broker-dealers in complying with Rule 606 and continues to add to the ongoing operational costs.

There are different ways that the wording proposed in the Regulatory Notice could be modified to address this issue. One approach would be to reference a “venue or broker” where a “venue” is currently referenced and to change “routed for execution” to “routed” or “routed for execution or further routing” or “routed for execution (by the recipient or another party)”.

II. Responses to specific questions from FINRA

In this section, FIF members respond to the specific questions presented by FINRA in the Regulatory Notice.

Question 1: Potential benefits of the report

As noted above, this comment letter does not express either support or opposition to the rule proposal as different FIF members have differing views about the advisability of the proposed routing disclosure reports.

Question 2: Potential costs; unintended consequences

Potential costs

The costs to implement the proposed OTC routing reports will depend on the details of the final rule that is adopted. In particular, if look-through is required, this will greatly increase the cost for the report as significant and ongoing coordination will be required among multiple layers of market participants. Look-through also raises numerous interpretive questions that add significant costs to implementation and ongoing compliance. If the recommendation above to exclude look-through reporting is adopted, this will significantly reduce the implementation and ongoing operational costs.

Unintended consequences

FINRA notes in the Regulatory Notice that “increased transparency into order routing practices in the market for NMS stocks may lead broker-dealers to change how they route held orders in ways that reflect positively on their routing decisions, but that may be suboptimal for customers on execution quality dimensions that are less easily observable.”⁵ FIF members agree with this concern. One approach

⁵ Regulatory Notice 21-35, p. 11.

to address this concern would be for FINRA, in connection with the adoption of an order routing disclosure requirement for OTC equities, to publish guidance to investors on the purpose and content, and potential limitations, of the OTC routing reports. A good example of this type of guidance is the Information Notice issued by FINRA on May 10, 2019 that provides helpful guidance to the public on “Understanding Short Sale Volume Data on FINRA’s Website.”⁶

As an example of guidance that could be provided by FINRA, FINRA could inform investors that there are a significant number of OTC stocks that have a limited number of available execution venues. In many cases, an OTC stock will only have one or two market makers. There is a potential risk that investors viewing the report would see a high percentage of order flow being routed to one or two venues without appropriate context of the limited choices available to the customer-facing broker-dealer. FINRA could identify this as a factor for investors to consider when reviewing a broker-dealer’s OTC routing report.

Question 3: Time period for implementation

The industry required significant time to implement the 2018 amendments to Rules 600, 605 and 606, resulting in the Commission granting an extension of the implementation dates that were provided for in the amendments.⁷ Two significant and related contributors to the implementation delay were the industry’s need for regulatory guidance relating to the amendments and the complexity of the look-through reporting requirements. It is critical that the implementation schedule for any rule change allow sufficient time for industry members to identify and obtain guidance from FINRA on applicable interpretive questions. It is also critical that the wording of the rule allow FINRA sufficient flexibility to address challenges that firms might identify during the implementation process.

Question 4: Reporting timeframe; centralized publication of routing reports

FIF members agree with FINRA’s proposal to maintain the same quarterly reporting timeframe as applies for Rule 606 reporting. FIF members support centralized publication of Rule 606 reports and the proposed OTC routing reports through the FINRA website or a third-party provider website in a manner that can be accessed by all market participants at no cost.

Question 5: Categories of OTC equity securities

FIF members believe that the reporting categories proposed by FINRA are appropriate. FIF members note that there are a significant number of OTC stocks that have a limited number of available execution venues, and that these stocks would not be reported separately based on FINRA’s proposed categories. This is an example where securities with different trading characteristics would be included in the same reporting category. Setting the reporting categories involves a trade-off between providing a report that is comprehensible for individual investors, on the one hand, and providing additional granularity and detail, on the other hand. On the whole, FIF members believe that it is important not to over-complicate the report for individual investors and support the categories proposed by FINRA.

⁶ Available at <https://www.finra.org/rules-guidance/notices/information-notice-051019>.

⁷ Exchange Act Release No. 85714 (Apr. 29, 2019), 84 FR 18136 (Apr. 30, 2019).

It is important that FINRA publish and maintain a file of which symbols are included in each OTC equity category and that this file be accessible to all industry members without charge. Making this file available on a quarterly basis will ensure consistent reporting among member firms.

Question 6: Grey market securities

FIF members agree with FINRA's decision not to provide a separate reporting category for grey market securities. While grey market securities often involve customized liquidity sourcing, the level of trading in grey market securities is de minimis relative to overall trading in OTC equity securities. This means that inclusion of grey market securities within the other proposed reporting categories should not impact the reported data in any meaningful way.

Question 7: Held and not held orders; Rule 606(b)(1)-type report

Held and not held orders

FIF members support FINRA's proposal to limit the OTC routing reports to held orders. The proposed OTC routing reports are intended for retail investors, and limiting the report to held orders is consistent with this objective. As stated by the Commission in the Rule 606 Amendments Adopting Release:

By contrast, the Commission's concern regarding how broker-dealers handle held orders is less about the difficulties posed by more automated, dispersed and complex order routing and execution practices. Rather, the Commission believes that enhanced disclosures for held orders should provide customers with more detailed information including with respect to the financial inducements that trading centers may provide to broker-dealers to attract immediately executable trading interest, as opposed to the different information geared towards not held NMS stock orders that is set forth in Rule 606(b)(3). As noted above and discussed below, the quarterly public disclosures required under Rule 606(a) are indeed being enhanced to provide more detail regarding financial inducements to broker-dealers, and the Commission believes that these disclosures are more appropriately tailored to the characteristics of held order flow and the needs of customers that use held orders.⁸

Rule 606(b)(1)-type report

FIF members support FINRA's proposed approach not to require a Rule 606(b)(1)-type report for OTC equities. FIF members believe that institutions, upon request, can obtain OTC routing information from broker-dealers that is equivalent to the information provided for in Rule 606(b)(1), even though it is not a legal requirement for broker-dealers to provide this information for OTC equities. Accordingly, FIF members do not believe that a separate Rule 606(b)(1)-type report for OTC equities should be required.

⁸ Rule 606 Amendments Adopting Release.

While FIF members do not believe that this should be required, FIF members note that it would not be a significant burden for firms to add OTC equities to the current Rule 606(b)(1) reports.

Question 8: Content of OTC routing reports

FIF members agree with the proposed content for the report subject to the comments set forth in the other sections of this letter. FIF members recommend that the FINRA order routing reports utilize a similar schema as is used for the existing Rule 606(a) reports, to the extent possible, but acknowledge that certain changes to the schema will be required to reflect that the Commission and FINRA reports will have some fields that are different. FIF members propose that the requirement to report on the number of directed orders be removed from the report because the routing decision in these cases is outside of the control of the broker-dealer.

Question 9: Break out by order type

FIF members support FINRA's approach of not breaking out the report by order type. Classifying a limit order as marketable or non-marketable is contingent on a national best bid and offer (NBBO) being available on a continuous basis. Since market makers are not mandated to provide continuous firm quotes for OTC equities, there is no certainty of a BBO being available on a continuous basis for any OTC equity. This means that classifying limit orders as marketable or non-marketable is not feasible. Further, since marketable limit orders share certain characteristics with marketable orders, differentiating between market and limit orders without separately differentiating between marketable and non-marketable limit orders could be misleading.

Question 10: Disclosing aggregate payments

FIF members agree with FINRA's proposal to require reporting of payments per executed order, as this is consistent with current industry practice.

Question 11: Reporting significant venues

Which entities should be reported

For the reasons discussed in detail in Section I of this letter, a customer-facing broker-dealer should report the broker or venue to which the customer-facing broker-dealer routes the customer's order.

Orders executed through OTC Link

There are various order handling scenarios involving OTC Link that will require guidance from FINRA. For example, how should a firm report if it receives a held order from a customer and negotiates that order with one or more market makers through OTC Link? One potential approach in this scenario is for the firm to report any OTC Link market maker that it executes against. FIF members propose that FINRA, prior to the adoption of any final rule, meet with industry members to identify the potential OTC Link scenarios and discuss how they should be reported.

Routes to brokers and venues outside the US

FIF members have two different views about reporting routes to brokers and venues outside the US. FIF proposes that either approach should be permitted and that the reporting firm should indicate on its webpage accompanying the routing reports which approach it has adopted. The following are the two approaches:

- Some FIF members believe that reporting in these scenarios should be consistent with CAT. If a reporting broker-dealer receives a customer order and knows that the order can only be executed outside the US, the broker-dealer should not include that order in its order routing report. This applies even if the foreign issuer has sponsored or unsponsored F shares in the US. If the reporting broker-dealer knows that the order will be executed in the US or is not certain whether the order will be executed in the US or in a foreign country, the broker-dealer should include the order in its order routing report. Consistent with the discussion in Section I of this comment letter, the reporting broker-dealer should report the broker or venue to which the reporting broker-dealer routes the customer order.
- Some FIF members believe that it will be a challenge to identify and filter those scenarios where an order can only be executed outside the US. These FIF members propose that all orders for F shares should be reportable, even if the reporting broker-dealer knows that the order will be executed outside the US. Consistent with the discussion in Section I of this comment letter, the reporting broker-dealer should report the broker or venue to which the reporting broker-dealer routes the customer order.

Under either approach, if a foreign issuer does not have F shares in the US, the order would not be reportable. The discussion above does not address securities that are inter-listed on a US exchange, as those securities would be covered under Rule 606(a), including any applicable exemptions under that rule.

Exemption for venues that receive less than 5% of non-directed orders

The Commission has exempted firms from including on their Rule 606 reports venues that receive less than 5% of a firm's non-directed orders as long as the firm has disclosed on the report venues that have received at least 90% of the firm's total non-directed orders for the applicable section. The Commission has provided the following background relating to this exemption:

Where, however, a broker-dealer routes the great majority of its orders for a section of the report to only a few venues, it also might route orders to other venues that fall within the top ten, but actually receive only a small number of orders. The inclusion of these venues in quarterly reports would not provide materially more useful information to investors, yet could impose a significantly higher compliance burden. Consequently, the Commission has exempted broker-dealers from the disclosure requirements of paragraph (b)(1)(ii) of the Rule with respect to execution venues that receive only a small percentage of the non-directed orders. Under the exemption, a broker-dealer is

not required to identify execution venues that received less than 5% of non-directed orders for a section of the broker-dealer's quarterly report, as long as it has identified the top execution venues that in the aggregate received at least 90% of the broker-dealer's total non-directed orders for the relevant section.⁹

FIF members recommend that FINRA provide this same exemption for the proposed OTC routing reports and that this exemption be incorporated explicitly within the applicable FINRA rule.

Question 12: Material aspects disclosure

FIF members request that FINRA provide additional guidance on the level of detail that would be required for the material aspects disclosure. For example, would the guidance in footnote 397 of the Rule 606 Amendments Adopting Release apply?

Question 13: Rule 606(b)(3) and Rule 605-type disclosures

Rule 606(b)(3)

As discussed in the response to Question 9, market makers are not mandated to provide continuous firm quotes for OTC equities. This means there is no certainty of a BBO being available on a continuous basis for any OTC equity. Since Rule 606(b)(3) execution quality data is based on the NBBO as a benchmark, Rule 606(b)(3) as currently designed would not work for OTC equities.

In addition, FIF members spent significant resources to comply with Rule 606(b)(3), and FIF members are not aware of any demand from customers for a similar-type report for OTC equities. Implementation of the Rule 606(b)(3) look-through requirements has been very challenging for FIF members. Look-through for OTC equities would present the additional challenge of how to report the various OTC negotiation workflows on a look-through basis, including scenarios where a customer-facing broker-dealer engages in negotiation with multiple market makers through the OTC Link ATS. As a potential alternative (as discussed above in the response to Question 7 above), it would not be a significant burden for firms to add OTC equities to the current Rule 606(b)(1) reports.

Rule 605

As discussed in the response to Question 9, market makers are not mandated to provide continuous firm quotes for OTC equities. This means there is no certainty of a BBO being available on a continuous basis for any OTC equity. Since Rule 605 execution quality data is based on the NBBO as a benchmark, Rule 605 as currently designed would not work for OTC equities.

⁹ Division of Market Regulation: Staff Legal Bulletin No. 13, "Frequently Asked Questions About Rule 11Ac1-6", available at <https://www.sec.gov/interps/legal/mrslb13.htm#q2>.

Question 14: Facilitating investor access and understanding of existing Rule 606(a) disclosures

FIF members support centralized publication of Rule 606 reports through the FINRA website or a third-party provider website in a manner that can be accessed by all market participants at no cost. This would provide a significant benefit to the public and industry members.

More generally, FIF members recommend that the SEC, FINRA, the other SROs and FINRA CAT consider how current reporting systems such as the Consolidated Audit Trail can be leveraged to reduce the general reporting burden for firms. In particular, if data is available to the regulators through one reporting system, firms should be relieved of the responsibility to report the same data through another reporting system. One example of FINRA leveraging existing data for reporting purposes is FINRA's weekly reporting of trading information for OTC transactions in NMS stocks and trading information for OTC equity securities executed outside of alternative trading systems, as set forth in FINRA Rules 6110 and 6610.

FIF members recommend that FINRA, in connection with the adoption of an order routing disclosure requirement for OTC equities, provide guidance to investors on the purpose and content, and potential limitations, of the OTC routing reports. A good example of this type of guidance is the Information Notice issued by FINRA on May 10, 2019 that provides helpful guidance to the public on "Understanding Short Sale Volume Data on FINRA's Website."¹⁰

FIF appreciates the opportunity to comment on Regulatory Notice 21-35. If you would like clarification on any of the items discussed in this letter or would like to discuss further, please contact me at howard.meyerson@fif.com.

Very truly yours,

/s/ Howard Meyerson

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Managing Director, Financial Information Forum

¹⁰ Available at <https://www.finra.org/rules-guidance/notices/information-notice-051019>.

¹¹ The signatory to this comment letter, prior to his current position at FIF, participated as an industry representative on a FINRA Subcommittee on Possible Order Execution and Routing Disclosures in the OTC Marketplace. The views expressed in this letter do not represent the views of FINRA or any FINRA Committee or Subcommittee.