

Regulatory Notice

12-07

Trade Reporting

FINRA Requests Comment on Proposed Amendments Relating to Reporting of OTC Trades Executed in a Mixed Capacity

Comment Period Expires March 26, 2012

Executive Summary

FINRA requests comment on a proposal to amend FINRA trade reporting rules relating to the reporting of OTC trades in equity securities that are executed by a member firm in a mixed trading capacity (*e.g.*, a single trade execution by a firm as principal and agent). FINRA is considering alternative approaches, such as (1) requiring firms to report a mixed-capacity trade as multiple trade executions with the member firm's capacity properly identified in each trade report, or (2) permitting a mixed-capacity trade to be reported in a single trade report and requiring firms to submit a non-tape report linked to the original trade report to identify the portion of the trade executed in a different capacity (*i.e.*, agent, principal or riskless principal).

Questions concerning this *Notice* should be directed to:

- ▶ Legal Section, Market Regulation, at (240) 386-5126; or
- ▶ Office of General Counsel at (202) 728-8071.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 26, 2012.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

February 2012

Notice Type

- ▶ Request for Comment

Suggested Routing

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

Key Topics

- ▶ Agency
- ▶ Alternative Display Facility
- ▶ Mixed Capacity
- ▶ NMS Securities
- ▶ OTC Equity Securities
- ▶ OTC Reporting Facility
- ▶ Principal
- ▶ Restricted Equity Securities
- ▶ Riskless Principal
- ▶ Trade Reporting
- ▶ Trade Reporting Facilities

Referenced Rules & Notices

- ▶ FINRA Rule 6282
- ▶ FINRA Rule 6380A
- ▶ FINRA Rule 6380B
- ▶ FINRA Rule 6622
- ▶ FINRA Rule 7230A
- ▶ FINRA Rule 7230B
- ▶ FINRA Rule 7330
- ▶ NTM 01-85



Financial Industry Regulatory Authority

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background & Discussion

FINRA rules generally require that reports of over-the-counter (OTC) transactions in equity securities³ accurately reflect the trading capacity (*i.e.*, agent, principal or riskless principal) of the reporting firm and any member firm on the contra side of the trade. The information can be provided in a single report, if the reporting firm submits trade information for both sides of the trade, or it can be provided in a combination of reports, if the reporting firm and contra side each submit its own trade information.⁴

In some instances, a firm may act in different capacities with respect to a single trade execution (*e.g.*, the firm combines multiple orders in different capacities at the same price and executes the combined orders as a single trade (referred to as a “mixed-capacity” trade)).⁵ However, trade reports submitted to FINRA can only accommodate one capacity code, and, as a result, a trade executed by a firm in a mixed capacity of agent and principal is reported as either agent or principal; the trade report cannot reflect that the firm acted in both capacities.

In December 2001, FINRA published *Notice to Members (NTM) 01-85*, which provides relief to firms with respect to reporting the capacity code for mixed-capacity trades. As indicated in *NTM 01-85*, a mixed-capacity trade can be reported in a single trade report, with a single capacity code, and firms have the option of submitting a non-tape report⁶ to FINRA to accurately reflect the capacity for a mixed-capacity trade. For example, if a firm executes an OTC trade for 10,000 shares in a mixed capacity of 6,000 shares as principal and 4,000 shares as agent and reports the trade with a capacity of principal, *NTM 01-85* provides that the firm may—but is not required to—submit a non-tape report to FINRA to show that it executed 4,000 of those shares as agent.

Based on a review of trade report data, FINRA has determined that firms rarely submit the voluntary non-tape reports. As such, mixed-capacity trade reporting provides less than optimal information for FINRA’s regulatory surveillance systems that rely on capacity codes.

Request for Comment

FINRA is proposing to amend its trade reporting rules to ensure that FINRA receives accurate trade data for trades executed in a mixed capacity and is considering at least two alternative approaches, which are described below.

FINRA notes that the relief granted to firms in *NTM 01-85* was intended to address technological constraints that existed at the time that prevented certain trading systems from separately reporting each component of a mixed-capacity trade.⁷ FINRA does not believe that such constraints exist today.⁸ Thus, under both approaches, firms would no longer be able to rely on the relief provided in *NTM 01-85* and would no longer have the option of reporting a mixed-capacity trade in a single trade report and submitting a non-tape report to correct the capacity.

Proposal

Reporting Mixed-Capacity Trades as Multiple Trade Executions

One approach that FINRA is considering is to expressly require firms to report a mixed-capacity trade as multiple trade executions with the firm's capacity properly identified in each trade report. Unless the trade qualifies for an exclusion from reporting for public dissemination purposes under FINRA trade reporting rules, each trade report would be submitted for dissemination (a "tape report"). For example, if Firm A executes a trade for 10,000 shares in a mixed capacity of 6,000 shares as principal and 4,000 shares as agent, Firm A would be required to report the trade in two reports: one tape report for 6,000 shares with a capacity of principal and a second tape report for 4,000 shares with a capacity of agent.

This requirement would apply whether the party acting in a mixed capacity is the reporting firm or a member firm on the contra side of the trade. For example, if member Firm A routes an order to Firm B for 10,000 shares in a mixed capacity of 6,000 shares as principal and 4,000 shares as agent, and Firm B has the reporting obligation under FINRA trade reporting rules, Firm B would be required to report the trade in two reports: one tape report for 6,000 shares with Firm A's capacity identified as principal and a second tape report for 4,000 shares with Firm A's capacity identified as agent.

In both of the above examples, it would not be permissible to report the entire 10,000 share mixed-capacity trade in a single trade report identifying a single capacity of either agent or principal. A member firm that routes a mixed-capacity order to a firm for execution would be required to identify the individual components of the order so that the firm executing and reporting the trade could properly report the trade. If the firm cannot do so, then it would need to route the components of the order separately (e.g., rather than routing a mixed principal and agency order, the firm would route an agency order and a separate principal order).

Mandatory Submission of Non-Tape Reports

A second approach that FINRA is considering is to continue to permit firms to report mixed-capacity trades in a single trade report and to mandate the submission of the non-tape reports that are currently voluntary, as provided in *NTM 01-85*. For example, if Firm A executes an OTC trade for 10,000 shares in a mixed capacity of 6,000 shares as principal and 4,000 shares as agent and reports the trade to FINRA in a single tape report with a capacity of principal, Firm A would be required to submit a non-tape report to FINRA to show that it executed 4,000 of those shares as agent.

In another example, if member Firm A routes an order to Firm B for 10,000 shares in a mixed capacity of 6,000 shares as principal and 4,000 shares as agent, and Firm B has the reporting obligation under FINRA trade reporting rules, if Firm B reports the trade in a single tape report with Firm A's capacity identified as principal, under this proposed approach, Firm A would be required to submit a non-tape report to FINRA to show that it executed 4,000 of those shares as agent.

This proposed approach is similar to current FINRA trade reporting rules that allow firms to report OTC riskless principal transactions in two separate reports: (1) a tape report to reflect the initial leg of the transaction, with the capacity marked as principal, and (2) a non-tape report to reflect the offsetting, "riskless" leg of the transaction, with the correct capacity of riskless principal.⁹

If FINRA were to mandate the submission of non-tape reports to correct the capacity for a member firm acting in a mixed capacity, firms would be required to link the tape and non-tape reports by providing the same unique identifier in both reports to enable FINRA staff to identify related reports in the audit trail.

FINRA welcomes comments on all aspects of the proposals discussed in this *Notice*, and specifically encourages comments on the following:

- ▶ What percentage of your firm's trading is done in a mixed capacity?
- ▶ What are the technological implications and burdens associated with each of the proposed approaches described above?
- ▶ How much time would firms need to make the necessary systems changes to implement each of the proposed approaches described above?
- ▶ Is there another approach or variation on the two approaches described above that FINRA should consider?

- ▶ If FINRA were to mandate the submission of non-tape reports—which would require the use of a unique identifier to link tape and non-tape reports—should the identifier be:
 1. a unique identifier that is generated and submitted by the firm (*e.g.*, as a new field in both the tape and non-tape reports);
 2. a control number assigned by the trade reporting facility on the confirmation of receipt of the tape report that would then be entered by the firm submitting the non-tape report; or
 3. some other linkage mechanism?

The comment period expires on March 26, 2012.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NTM 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. Specifically, these are (1) OTC transactions in NMS stocks, which are reported through the Alternative Display Facility (ADF) or a Trade Reporting Facility (TRF); and (2) OTC transactions in OTC equity securities, as defined in FINRA Rule 6420 (*i.e.*, non-NMS stocks), and transactions in restricted equity securities, as defined in FINRA Rule 6420, effected pursuant to Securities Act Rule 144A, which are reported through the OTC Reporting Facility (ORF).
4. *See* Rules 6282(c) and (d), 7230A(c), 7230B(c) and 7330(c).

Under FINRA rules, unless the contra side will have an opportunity to provide its own trade information—*i.e.*, unless the contra side is a member firm using the trade comparison functionality of the ADF, FINRA/Nasdaq TRF or ORF—the reporting firm is responsible for providing complete and accurate information for both sides of the trade, including capacity information from the contra side perspective. Because the FINRA/NYSE TRF does not offer such functionality, reporting firms are responsible for accurately and completely providing all information required for the contra side any time they report to the FINRA/NYSE TRF.

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5. FINRA notes that, depending on the specific circumstances, the use by a firm of mixed-capacity trading could be detrimental to a customer, for example, if the principal portion of a mixed agency and principal trade delays the overall execution of the order. While FINRA rules do not prohibit mixed-capacity trading, firms must evaluate the use of mixed-capacity trading with respect to their best execution obligations to customers.
6. A non-tape report is a report that is submitted to FINRA, but is not reported to the appropriate exclusive Securities Information Processor for public dissemination purposes.
7. For example, at that time, executions via a NASDAQ system (*e.g.*, SOES or SelectNet) against a market maker's quote resulted in a trade report that defaulted the market maker's capacity to principal, even if the market maker's quote represented multiple orders of mixed capacities (*e.g.*, principal and agent).
8. For example, the NASDAQ Exchange's current trading platform allows for the entry of orders in different capacities at the same and multiple price levels. While the NASDAQ Exchange consolidates such orders in a single quote, executions are reported on the individual order level with the correct capacity. While these are not OTC trades, FINRA believes that this is representative of changes in technology in this area.
9. See FINRA Rules 6282(e)(1)(C)(ii), 6380A(d)(3)(B), 6380B(d)(3)(B) and 6622(d)(3)(B).