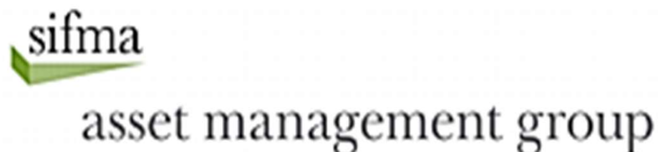

September 20, 2022

VIA ELECTRONIC SUBMISSION

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Proposed Trade Reporting Requirements for Over-The-Counter Options Transactions (FINRA Regulatory Notice 22-14)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to respond to the request for comment by the Financial Industry Regulatory Authority, Inc. ("FINRA") on its Regulatory Notice 22-14 ("RN 22-19"). In the notice, FINRA proposes to establish for the first time a requirement for firms to report transactions in an OTC option that is a put or call on one or more listed underlying securities (including an option on an individual underlying security or an option on a basket of securities that meets the definition of a "conventional index option"), including transactions executed by the firm on either a principal or agency basis.[2] The proposal further provides that it "is limited to options with terms that are identical or substantially similar to listed options, including FLEX options."

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] As FINRA notes in RN 22-14, "OTC options" are options that meet the definition of "conventional option" under FINRA Rule 2360(a)(9). The term "conventional option" means: (A) any option contract not issued, or subject to issuance, by The Options Clearing Corporation (OCC); or (B) an OCC Cleared OTC Option. The term "OCC Cleared OTC Option" means any put, call, straddle or other option or privilege that meets the definition of an "option" under Rule 2360(a)(21), and is cleared by the OCC, is entered into other than on or through the facilities of a national securities exchange and is entered into exclusively by persons who are "eligible contract participants" as defined in the Exchange Act. Firms view acting on an agency basis in the context of this proposal to be limited to

As described below, SIFMA members have certain significant concerns regarding the proposal that we believe FINRA should address prior to filing any formal rulemaking proposal with the Securities and Exchange Commission ("SEC"). Most notably, SIFMA members are concerned about the lack of clarity regarding the reporting criteria set forth in the proposal and recommend that FINRA provide greater certainty, in the manner we describe below, regarding the criteria to allow firms to properly build systems and processes to capture reportable OTC option transactions and avoid reporting differences among firms.

We also recommend that FINRA give firms sufficient time to develop the systems necessary to implement this proposal due to the significant amount of other systems-related work firms are currently undertaking (e.g., developing and refining systems to report to the Consolidated Audit Trail ("CAT")), as well as the substantial amount of work firms will be required to undertake related to pending rulemakings from the SEC such as the move to T+1 securities settlement, pending and recently approved FINRA rule proposals on TRACE reporting, and other outstanding rule proposals. Our responses below are designed to track the questions from RN 22-19. Once we receive further clarity on the scope of this proposal, we will seek feedback from our membership regarding the appropriate length on such implementation period. We do not expect this time period to be less than eighteen months.

I. Use of OTC Options

Reason for Trading "Look Alike" OTC Options

At the outset, we note that the use of OTC options is often driven not by SIFMA members, but by buy side demand, and that there is vigorous competition among SIFMA members engaged in the OTC options business for this business. The OTC options buy side market is institutional in nature, and generally consists of large U.S. and international institutional counterparties. These buy side counterparties choose to trade options bilaterally for a variety of reasons, such as maintaining anonymity while establishing positions and/or trading in large size. These entities also may choose OTC option transactions because they often are less costly than listed options transactions. This is because OTC options transactions do not involve paying exchange fees and clearing fees to The Options Clearing Corporation.

We also note that OTC options are typically governed by a master agreement (e.g. an ISDA Master Agreement) that includes protections such as default provisions and remedies, the exchange of margin, and payment netting. Master agreements are considered prudent risk management by many SIFMA members and their buy side counterparties.

Trading Under LOPR Thresholds

While SIFMA members do facilitate OTC options transactions that are for less than 200 contracts, most OTC options transactions are above this threshold. Therefore, it is likely that

"[t]rades required to be intermediated by a U.S. broker-dealer under SEA Rule 15a-6(a)(3) or 15a-6(a)(4)," as noted in RN 16-17 and used in LOPR reporting.

most firms would trade OTC options positions large enough to trigger a LOPR obligation under the current 200 contract reporting threshold.

II. Comments on FINRA's Proposal

Product Definitions

In RN 22-14, FINRA states that the proposal "is limited to options with terms that are identical *or substantially similar* to listed options, including FLEX options" (emphasis added). Yet the proposal then goes on to provide a three-part test (the "Three Part Test") that an OTC option transaction is reportable "where (1) there is a listed option on the same underlying security (e.g., a single stock or an index), or the OTC option is overlying one or more U.S.-listed securities; (2) the option type is a put, a call, or an option type related to a put or a call; and (3) where the exercise style is one of the following: American, European, Asian, Cliquet or Binary."[3]

There are several potential issues with the "substantially similar" standard and the Three Part Test as currently drafted. As a threshold matter, we note that these two standards potentially conflict with one another. For instance, an OTC option on an NMS stock that has at least one term different than a non-FLEX listed option on the same equity, such as a different strike price or expiration date, may be viewed by certain firms as not being "substantially similar" to that listed option because it presents the OTC option holder with different investment outcomes. However, that same OTC option may nonetheless satisfy the Three Part Test. Some SIFMA members may exclude this product from trade reporting based on the "substantially similar" standard, while others may include it based on the Three Part Test.

A second example would be an OTC option on an NMS stock that is cash-settled, which may be viewed by certain firms as not being "substantially similar" to a listed option on the same equity because all single name listed options are physically settled, but might nevertheless satisfy the Three Part Test.

A third example relates to an OTC option on an NMS stock that has an Asian, Cliquet or Binary exercise style. Based on our review of exchange listing rules, Asian and Cliquet options are only permitted to be listed as FLEX options on broad-based indexes.[4] Similarly, our review has indicated that binary options are only permitted to be listed on broad-based indexes.[5] Thus, only listed broad-based index options are permitted to have these exercise styles. While an OTC option on an NMS stock with one of these exercise styles would not be "substantially similar" to a listed option on the same equity because listed options are not permitted to have these exercise styles, that OTC option might nonetheless meet the Three Part Test.

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[3] We suggest that FINRA consider changing the reference to "U.S. listed securities" to "NMS stocks" as that is the term used in the options exchanges' listing rules with regard to securities eligible to have options listed on them. See, e.g., Cboe Rule 4.3(a).

[4] See, e.g., Cboe Rule 4.21.

[5] See, e.g., Cboe Rule 4.16.

We would also note that different SIFMA members may take different views as to what constitutes a "substantially similar" transaction. This could lead to even further inconsistent and potentially misleading trade reporting data across the marketplace.

Accordingly, we propose that FINRA delete the Three Part Test altogether and leverage existing FINRA Rule 2360 to clarify what is meant by the phrase "substantially similar." More specifically, an OTC option would be considered "substantially similar" to a listed option if the OTC option (a) referenced the same underling security or index,[6] (b) was within one strike price interval of the listed option term; and (c) was no more than one expiration month apart from the listed option term.[7] This provision in Rule 2360 defines when an OTC option can be used as a one-to-one hedge for purposes of FINRA and exchange position limit rules, and is thus an appropriate standard for the proposal because it captures OTC options that provide holders with the same or substantially similar economic exposure to a specific listed option.

Reporting Fields

With regard to the proposed reporting fields included in Appendix A of the proposal, we believe that certain of the fields need to be changed or clarified in the manner we describe below if FINRA moves ahead with the proposal. In particular, we recommend that the "Record Type" field be renamed as the "Event Type" field considering that FINRA describes the field as referring to a new trade, correction and exercise. In addition, firms would need guidance on how to fill out the "Settlement Style" field (i.e., cash or physical) if the OTC option exercise style can be chosen at or amended prior to expiration.

Perhaps most significantly, the "Order Received Time" field should be deleted altogether, because while discussions regarding an OTC option transaction can take place over time, the order only becomes firm once there is mutual agreement between the parties regarding the terms and the option price becomes firm. Similarly, the "Execution Timestamp" field should be replaced by "Event Timestamp" field and the description of the field should be modified so that it covers other events such as novations, exercises and other reportable events. Additionally, guidance should be provided on how to fill out the "Option Strike Price" field for those trades in which the option strike price is not known at the time of transaction. As for the "Exercise Style" field, we recommend that the description of it be limited to American or European style for single name OTC options as explained above. Similarly, we recommend that the "Creation Date" field be removed for single name OTC options, which would only be reportable for American and European style OTC options if our recommendation above is adopted.

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[6] We have included a reference to "index" in this provision so that our proposed test also would cover an OTC option based on the same index as a listed option. While we recognize that there may be concerns about firms removing one or two names from an index on which an OTC option is based to avoid the reporting obligation, we note that there are various practical concerns that would deter such behavior, such as the need for firms to create bespoke pricing models and documentation for such OTC options, as well as client reluctance to establish positions on non-standardized indexes. In addition, we note that such OTC options would be reportable to LOPR, so that if FINRA sees a spike in the reporting of such options in the future, it could change the index reporting standards at such time to require the reporting of such options.

[7] See FINRA 2360(b)(3)(A)(ii)(a)(7).

Further, we note that there is no need for a "Settlement Currency" field as all OTC option transactions that the proposal appears to be designed to catch would settle in U.S. dollars (i.e., OTC options on NMS stocks and indexes). Finally, firms need more guidance on when amendments to the original terms of an OTC options contract need to be reported because there may be updates to reported fields that are not material.

Costs and Time

With regard to the costs and time associated with implementing the proposal, firms that do not have order management systems (OMS) that automatically capture the details of OTC option transactions could face significant expenses. Even for firms that do have such systems, they will need to reprogram them to be able to capture order receipt time and premium, which are not fields that must be captured today. Although some of the OTC option information FINRA proposes to be reported is captured by firms today as part of their LOPR reporting, firms would still need to update and modify back-office systems and processes to be able to report this new information to FINRA. For example, firms' LOPR reporting systems and processes are set up to report on a trade date plus one (T+1) basis. In the proposal, however, FINRA is contemplating trade date (T) reporting.

Most significantly, any work firms would need to undertake to implement the proposal would compete for scarce resources from the firms' information technology teams, who are currently focused on CAT implementation plus any work that will arise out of pending SEC rule proposals like its T+1 accelerated securities settlement rule proposal and stock loan reporting proposals, and pending and recently approved FINRA rule proposals on TRACE reporting.[8]

Work related to these SEC proposals is expected to be very substantial and take up tremendous amounts of firm time and resources. Accordingly, to the extent FINRA moves forward with the proposal, we ask that it provide firms with sufficient time to allow firms to sufficiently plan, budget and staff its implementation. As noted above, we will ask for SIFMA member feedback on how long the implementation period should be after we have received updated guidance regarding the proposal's scope.

Potential Impact

At the end of RN 22-14, FINRA seeks comment on the potential impact of the proposal on the OTC options market and the concept of public dissemination of certain of the reported information regarding OTC options. While it is difficult to predict with certainty the potential impact of the proposal, there are several potential negative consequences that could arise if the proposal moves forward. To begin, if the costs associated with implementing non-public, regulatory reporting are too burdensome, SIFMA members may be less willing to offer OTC products to their clients. Alternatively, SIFMA members may offer OTC options only at higher

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[8] We are concerned that FINRA has not provided sufficient detail regarding the regulatory need for the data proposed to be collected pursuant to the new reporting obligation. For instance, FINRA states in the Regulatory Need section of RN 22-14 that "the data would allow FINRA to identify potentially manipulative behavior that can only be observed to a limited extent today relying on LOPR data," but FINRA provides no further discussion of why the existing LOPR data is limited and how the proposed reporting regime would help fill perceived gaps.

prices. This decrease in liquidity and/or increase in pricing will ultimately be passed along to clients, hurting customers and their portfolios. In addition, any public reporting regarding OTC options transactions could negatively impact liquidity and pricing even further.

We also are very concerned about the heightened risk of negative consequences for asset managers and their clients adversely impacted by such public disclosure. Public dissemination could create opportunities for front running and copycatting strategies, including through the reverse engineering of proprietary trading strategies. It could also threaten the value of fundamental research paid for by managers and investors by revealing through public reporting the analysis in that research. All of these negative consequences would hinder investment performance and increase costs for investors. The risks are particularly acute in our view with respect to large and/or lower liquidity trades given the potential for a "winner's curse" whereby the trade details for the winning dealer could publicly disseminated prior to the opportunity for such dealer to hedge its position in the market. Dealers which lost the trade could have the opportunity to trade ahead of the anticipated hedge and thereby increase the cost of the hedge to the winning dealer. The result would be to chill bidding on a trade and/or to raise the pricing to try to offset the downside of the "winner's curse". Liquidity and/or pricing would inevitably suffer with investors subject to the negative effects. For these reasons, we strongly believe that the costs and negative impacts on investors significantly outweigh the benefits of public dissemination of the reported information.

As the proposal acknowledges, if rule implementation is too burdensome, SIFMA members also may consider trading OTC options with certain counterparties out of their bank affiliates. This would run contrary to the rule's purpose and provide less visibility into the marketplace, instead of more.

Furthermore, and in contrast to the pricing of a listed options transaction, the pricing of a non-listed OTC options transaction can vary based on factors beyond the economic terms of the option, including, but not limited to, the credit of the counterparty and the amount and quality of the credit support (e.g. collateral, third-party guarantees or other credit support). Thus, public dissemination of individual OTC options transactions could provide misleading price data to the market, as the pricing of such transactions could vary due the counterparty's credit and/or the credit support provided.

Public dissemination could also enable market participants to identify the positions of specific market participants, resulting in adverse market impact for such participants. Consequently, we do not believe that any proposed public dissemination of OTC options activity would provide greater public benefits versus the harm to market participants imposed by the proposed concept.

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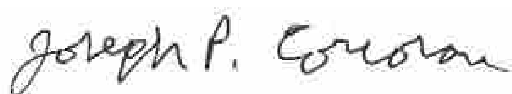
SIFMA appreciates the opportunity to respond to RN 22-14 and also your consideration of our comments as set forth above. We look forward to engaging with you further on the proposal and are more than happy to share our thoughts on it. If you have any questions or require additional information, please do not hesitate to contact us by calling Joe Corcoran at (202) 962-7383, Ellen Greene at (212) 313-1287, or William Thum at (202) 962-7381.

Sincerely,



Joseph Corcoran
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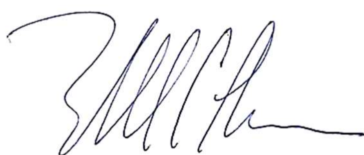

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