October 21, 2013

Via E-mail to rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR–FINRA–2013–039; Release No. 34-70482
SIFMA comment on FINRA proposed interpretation to clarify the classification and reporting of certain securities to FINRA (the "Proposal")

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Proposal. The Proposal seeks to adopt an interpretation to clarify the classification and the reporting of certain securities to FINRA (the "Proposed Interpretation").

SIFMA submits that any guidance regarding the trade reporting of hybrid securities should be consistent with current market practice and allow those securities currently being reported to FINRA's Trade Reporting and Compliance Engine ("TRACE") to continue to be reported in that system. As discussed in detail below, hybrid securities that are being reported to TRACE should continue to be reported to TRACE because:

- these securities have many characteristics that closely resemble fixed income instruments and such characteristics have historically been recognized by regulators as warranting debt-like treatment;
- such securities are critical to the capital raising efforts of financial institutions and are growing in importance given new regulations relating to capital requirements;

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

- consistent with longstanding market practice, investors evaluate these securities based upon their fixed income attributes and accordingly expect such securities to be reported to TRACE;
- changes to trade reporting classifications will likely cause investor confusion and harm liquidity in this critical market; and
- the modifications necessary to accommodate changing trade reporting classifications will cause unintended downstream impacts and unnecessary costs.

SIFMA is committed to working constructively with FINRA as it seeks to both provide clarity on trade reporting requirements and ensure related interdependencies are addressed, but we seek to do so in a manner that minimizes disruption to this important market and cost to market participants. SIFMA also seeks to partner with FINRA to ensure that FINRA members, as well as investors and vendors, are given sufficient time to undertake the significant systems changes that will be needed to accommodate any modifications to longtime trading practices that may be necessary under this Proposal or any subsequent proposal.

I. Introduction

SIFMA understands that the Proposed Interpretation is designed to provide clarity on the proper classification of certain hybrid securities for trade reporting purposes given that hybrid securities cover a wide spectrum of securities that have characteristics of both debt and equity (specifically, "hybrid preferred securities"). SIFMA's members, as broker-dealers and asset managers, and the constituencies they serve, issuers and customers, will be impacted by the Proposed Interpretation either directly as a result of reporting obligations or indirectly by way of the potential disruption in trade transparency or market liquidity. As such, SIFMA has a keen interest in the Proposed Interpretation and, in particular, in mitigating any potential confusion or unintended consequences associated with the possible adoption of the Proposed Interpretation.

SIFMA has identified significant concerns and possible confusion about the Proposed Interpretation. We are first and foremost concerned about the potential for disruption to the capital formation of banks, U.S. banks in particular, and other issuers given the significant reliance on the hybrid market to fortify capital levels under regulatory initiatives such as Basel III.

We further believe there should be greater regulatory consideration on the proposed characterizations for reporting purposes to take into account longstanding market practice which reflects a reasonable best effort by firms to comply given the unique characteristics of hybrid instruments. Some hybrid preferred securities, in particular hybrid preferred securities with a par value of $1,000, which the Proposed Interpretation would treat as equity, have historically been traded and settled with a debt convention and therefore trade reported through TRACE. We believe that post trade transparency goals have indeed been achieved with the current market convention and have best served investors, albeit in perhaps a different venue than envisioned by the Proposal. Accordingly, we believe that the regulatory scheme should permit such practice to continue and that for hybrid securities, the debt-like characteristics and subsequent debt trading convention should warrant TRACE reporting to best serve the transparency needs of investors.

We are also concerned that the Proposal does not contain the actual language of the interpretation that FINRA proposes to adopt, but rather provides a general description of the principles that it intends to incorporate into the actual interpretation. As a procedural matter and to ensure clarity of understanding, we believe issuers, investors and SIFMA's members should be provided the opportunity to review and comment on the exact language of the Proposed Interpretation in advance of any implementation of the Proposal. We are further concerned that the Proposal's definitional bifurcation of the market fails to address the full spectrum of preferred and hybrid securities and the classification could be better constructed to provide clarity and guidance in anticipation of further developments in this marketplace.

SIFMA believes that the Proposed Interpretation should be reconsidered to better balance the objectives of ensuring proper market functioning and providing post-trade transparency of the most useful information to investors, while at the same time addressing interdependencies among trading systems, reporting venues, clearance and settlement systems and asset servicing. Any final interpretations should provide sufficient clarity to ensure the consistent treatment of the diverse universe of hybrid preferred securities going forward. SIFMA is dedicated to working in concert with FINRA and other regulatory bodies to ensure the viability of the growing hybrid preferred securities market, prevent any unnecessary market disruption, and to ensure the necessary regulatory clarity.

At a minimum, and due to all the additional considerations and interdependencies we raise in this letter, we believe that any implementation of the Proposed Interpretation regardless of its final form should provide for a significant transition period, at least one year, to implement any necessary changes to both current market practice and, importantly, related technology and operational processes, so that there would be an orderly transition once any new guidance takes effect. These system changes will also impose significant costs upon a number of market participants, including SIFMA members, their vendors and vendors that provide transactional and price information to investors. Consistent with FINRA's commitment to engage in a cost/benefit analysis for its rule proposals,[2] SIFMA urges FINRA to consider more cost effective alternatives, including making changes to its trade reporting systems, that would accomplish its goals without imposing unnecessary burdens on market participants.

II. Preferred Securities are a Critical Part of the Capital Markets

Although preferred securities date back over 100 years, the hybrid preferred market came into existence in the 1980's and has evolved considerably over time. In response to a 1996 Federal Reserve Board ruling on Tier 1 capital, the hybrid preferred securities market expanded rapidly as issuers created new products that mix and match both debt and equity characteristics

[2] FINRA, Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking (Sept. 19, 2013), http://www.finra.org/web/groups/industry/documents/industry/p346389.pdf.

to achieve the particular tax, regulatory capital and rating agency treatment needs of the issuer and to meet the investment objectives of different classes of investors.[3] Importantly, this hybrid preferred market continues to be, and is increasingly, an important source of bank regulatory capital.

Our calculations show that since the beginning of 2000, there have been at least 779 hybrid preferred securities issued globally with an issue amount of over $336 billion, of which at least 663 issuances are currently outstanding with an issue amount of more than $224.3 billion.[4] Of these issuances, at least 627 hybrid preferred securities were issued in the U.S. markets with an issue amount of over $254 billion, of which at least 540 issuances are currently outstanding with an issue amount of more than $155.8 billion. A large percentage of the U.S. market issuances were from Financial Institutions Group ("FIG") issuers,[5] which accounted for 557 of the hybrid preferred securities issuance with an issue amount of more than $231.8 billion. In the U.S., at least 496 issuances are currently outstanding from FIG issuers with an issue amount of more than $137.9 billion.

There has been a significant amount of issuance activity in the hybrid market in the last few years. In 2012, at least 30 hybrid securities were issued globally with an issuer amount of over $28.9 billion. Of these issuances, at least 14 were issued in U.S. markets with an issue amount of over $16.4 billion with FIG issuers accounting for 11 U.S. market issuances worth $14.8 billion. Since the beginning of this year alone, there have been at least 20 hybrid preferred securities that were issued and sold in the U.S. worth over $20.2 billion, with FIG issuers accounting for at least 17 issuances worth over $15.5 billion.

As the data reflects, a significant percentage of hybrid preferred securities are issued by FIG issuers. Bank issuance of hybrid preferred securities are structured so as to be treated as Tier 1 capital under both U.S. and foreign regulatory regimes. In 2010, as part of the International Regulatory Framework for Banks developed by the Bank for International Settlements ("BIS"), known as Basel III, international regulators agreed to raise the common equity capital requirements for banking institutions from 2% to 4.5% by January 2015 and required a capital conservation buffer of 2.5%.[6] As of September 25, 2013, the BIS estimated that banking institutions had a shortfall of €126.4 (approximately $171 billion) in their Basel III

---

[3] Securities Litigation and Consulting Group, *The Risks of Preferred Stock Portfolios* (2010), http://www.slcg.com/pdf/workingpapers/Preferred%20Stock%20Paper.pdf.

[4] The data presented in this letter has been gathered from various sources and is accurate to the best of SIFMA's knowledge.

[5] FIG issuers consist mostly of banks, insurance companies and real estate investment trusts.

[6] BIS, *Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards* (Sept. 12, 2010), http://www.bis.org/press/p100912.pdf; *see also* BIS, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, p. 28 (June 2011), http://www.bis.org/publ/bcbs189.pdf.

requirements.[7] Additionally, regulators have proposed stricter leverage ratios, putting additional pressure on banking institutions to raise additional capital to finance their operations.[8] In a recent study of the impact of the modifications to leverage ratios, it was found that the leverage ratio will be the binding constraint on capital and, in the absence of significant deleveraging, may create an even larger capital shortfall.[9] The hybrid preferred securities market is expected to be an integral source of capital in banking institutions' efforts to meet these increased capital needs.[10]

The Proposed Interpretation has the potential to necessitate a significant shift in current market practice and may create confusion for investors in this market, impact the price and liquidity of these securities in the secondary market and affect the ability for issuers to tap the market with offerings of hybrid preferred securities to raise Tier 1 capital. Recharacterization of hybrid preferred securities as equity for trade reporting purposes could cause these investors to reduce their holdings of hybrid preferred securities which would have negative liquidity and valuation implications for the market, particularly for securities yet to be issued. For example, if such recharacterization impacted the security's eligibility for fixed income indices, certain institutional investors would be required to divest their holdings in the security as eligibility in indices is often a requirement for institutional investors to include such securities in their portfolio.

Recent experience provides evidence that such shift could be disruptive. As you know, several recently issued preferred securities that were structured as depository shares have been equity reporting via Over-the-Counter Reporting Facility ("ORF") as a result of FINRA's initial guidance in June of this year. Several institutional fixed income investors, the dominant holders of such securities, subsequently expressed concern that this method of reporting presents an obstacle to their ready access to trade reporting data and trade analytics that are vital for investment decisions. Accordingly, these investors have indicated to several dealers that further efforts to use equity reporting venues may significantly impact their willingness to participate in the market going forward. We believe such concern indeed reflects a broader sentiment and potential for market disruption. Accordingly, a failure to recognize and serve transparency in a

[7] BIS, *Basel III Monitoring Results Published by the Basel Committee* (Sept. 25, 2013), http://www.bis.org/press/p130925.htm (citing a Group 1 (larger institution) shortfall of €115 billion and a Group 2 shortfall of €11.4 billion).

[8] *See e.g.,* Office of the Comptroller of the Currency, OCC Approves Final Rule on Regulatory Capital; Proposes Doubling Leverage Ratio for the Largest Banks (July 9, 2013), http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-110.html (doubling leverage ratio for large banks).

[9] GFMA, *Responding to the Revised Basel III Leverage Framework* (Sept. 20, 2013), http://www.gfma.org/correspondence/item.aspx?id=536.

[10] *See, e.g.*, Frances Schwartzkopff, *Nykredit to Refinance $2 Billion With Preferred Stock, CoCos*, Washington Post (Oct. 3, 2013), http://washpost.bloomberg.com/Story?docId=1376-MU1TNW0YHQ0X01-62I5M57QTJPV48EBT0UI9DIPIT (explaining that European bank was issuing preferred stock and contingent convertible debt to meet its additional capital requirements under Basel III).

manner most useful to investors could have far reaching consequences on the liquidity of hybrid instruments. Therefore, it is critical that FINRA carefully consider the needs and desire of investors in determining its guidance as to the appropriate reporting venue for these securities and the distinction between debt and equity securities in this context.

III. Current Market Practice is Supported by the Characteristics of Hybrid Preferred Securities and Investor Expectations

Although there are many variations of hybrid preferred securities, these instruments tend to share core characteristics that have informed market practice. Hybrid preferred securities typically have a fixed coupon/dividend and do not provide voting rights beyond statutory requirements or that are often found in debt indentures[11] and may or may not mature at a specified date. In addition, some hybrid preferred securities are callable while others do not have this feature.

Investor expectations with respect to hybrid preferred securities have been shaped by the characteristics noted above, the many qualities that hybrid preferred securities share with debt securities and the historical trading conventions used for different market segments. Similar to debt securities, hybrid preferred securities typically trade on the basis of yield and credit quality rather than on potential for capital appreciation.[12] For this reason, investors in hybrid preferred securities make portfolio allocations based on yield, time to first call, and credit rating among other debt-like characteristics and institutional investors in particular often include hybrid preferred securities in their fixed income portfolios. Some hybrid preferred securities also trade and settle in the same manner as products priced on the basis of yield (*e.g.*, debt securities) with settlement prices that include separately calculated coupon/dividend payments.

Our review shows the hybrid securities market (inclusive of the hybrid preferred market) can encompass many different forms, including, but not limited to, trust preferred and depositary shares. Each form may mix and match debt and equity-like features, but each instrument typically carries core characteristics that have been historically recognized by regulators as warranting debt-like treatment – including a coupon/dividend rate that is either fixed (which may or may not be reset on specified dates based on benchmark interest rates) or variable based upon a formula independent of the issuer's financial performance. All these instruments generally hold a similar priority in the capital structure – to be paid after all other debt and prior to common equity. Each of these forms may also be issued in varying par amounts.

---

[11] For example, investors in some hybrid preferred securities are permitted to vote on any adverse amendment of the terms of the security. This type of limited voting right is a common term in debt indentures.

[12] *See* Securities Act Rel. No. 6753, 1988 WL 1516978, at *4 (Feb. 2, 1988) (SEC agreeing with commenters that similar to debt obligations, investors in preferred securities are "primarily concerned with yield").

For the vast majority of $1,000 par hybrid preferred securities,[13] the market practice is to trade over the counter ("OTC") in a fixed income convention (with counterparties discussing the notional amount of the security, its price and the carried accrued interest or dividends that are expressed separately from price) and thus report transactions to TRACE, the reporting venue for debt securities. Further, most $1,000 par hybrid preferred securities have a debt CUSIP that is used to facilitate settlement in a debt format.[14] As a result of the Proposed Interpretation, a significant number of $1,000 par hybrid preferred securities would be required to switch from a debt trade reporting format via TRACE to an equity reporting via ORF. The vast majority of hybrid security investors are fixed income investors. Accordingly, they are familiar with the fixed income trading and reporting convention, particularly the settlement of trades with separately stated accrued coupon/dividend payments. It is our understanding that such investors expect to find market transaction information about such securities in the same places that they find information about debt and other yield based instruments. Further, the equity trading convention of an all-in settlement price that includes any accrued coupon/dividend and other equity reporting requirements may limit fixed income investors' willingness to buy or trade hybrid securities.

Equity trade reporting systems, such as the ORF, were not designed to handle transactions in securities that trade in a debt convention with a notional amounts, price and accrued interest. The ORF data fields, for example, provide only for price per share and number of shares. They do not accommodate the entry of the accrued coupon/dividend that is carried with a transaction in a debt-like security. Accordingly, broker-dealers, vendors and information service providers will need to make significant enhancements to systems that do not currently connect to the ORF and will need work to ensure that essential data (historical and current) remains easily accessible to the market. As discussed later in this letter, significant transition time will be needed to make the required changes by a number of market participants and to do so in a manner that prevents market disruption. We also recognize that there are other regulatory interdependencies to routing securities through ORF that need to be considered.[15]

[13] We note that there are also $10,000, $25,000 and $100,000 par hybrid preferred securities that trade similarly to $1,000 par preferred securities. For ease of reference, this letter refers only to $1,000 par preferred securities.

[14] Preferred securities can also be issued in smaller denominations. Historically, these securities were most often listed on an exchange and as such market practice evolved to trade these securities in an equity format (number of shares, and share price - inclusive of any accrued interest or dividend). These preferred securities with smaller denominations are thus most often created with equity CUSIPs to accommodate equity settlement.

[15] We acknowledge that an alternative means to capture transactions subject to Section 31 and collect the related fees may be needed if transactions are not reported through ORF. As discussed in this letter, numerous market participants will be required to develop new trading conventions and systems for trading preferred securities if the hybrid preferred securities that are currently being reported to TRACE are to be instead reported on ORF. Before imposing these costs, and to the extent that investors transparency needs are already being met, FINRA should consider whether certain hybrid securities can be identified separately within TRACE for Section 31 purposes rather than rely solely on ORF as a means to do so. We believe the solution should properly balance the costs and benefits for all those impacted. We welcome the opportunity to discuss alternative tracking and collection mechanisms. Additionally, we believe further analysis is required to ensure that exchanges are properly characterizing preferred securities for Section 31 purposes.

IV. Current Market Practice Regarding TRACE Eligibility of Hybrid Preferred Securities is Consistent with Regulatory Precedent

We believe sufficient regulatory precedent exists to allow some hybrid preferred securities to be determined to be TRACE eligible and be trade reported in a debt format, particularly in light of investors' preference as reflected in current market practice. For over 20 years, regulators have provided guidance that treats some types of preferred securities as debt securities for a wide variety of purposes.[16] For example, when TRACE was first proposed in 1999, the NASD noted that it was responding to a call from the Chairman of the SEC to create a reporting system for debt *and preferred securities*.[17] In addition to the trade reporting context, preferred securities have been treated in the same manner as debt securities under a number of rules and regulations.

For purposes of establishing disclosure requirements for trade confirmations under Exchange Act Rule 10b-10, the SEC has recognized that factors such as yield and whether the security is rated by a nationally recognized statistical rating organization ("NRSRO") - items that are required to be disclosed on trade confirmations for debt securities, but not equity securities - are important disclosures for customers. As an example, in a 2004 rule proposal relating to the treatment of callable preferred securities under Exchange Act Rule 10b-10, the Commission stated:

> Investors often purchase shares of preferred stock for their dividend yield. If the preferred stock is callable and is repurchased by the issuer, then the investor may not be able to reinvest his or her proceeds in an instrument with an equivalent yield. This is particularly significant given that issuers are most likely to call preferred stock when interest rates are declining. Confirmation disclosure of this material information could alert an investor to any misunderstandings about the rights associated with the preferred stock, promote the timely resolution of problems, and better enable the investor to evaluate potential future transactions involving that security.[18]

In several other SEC rules, certain preferred securities are either included in the definition of debt securities or excluded from provisions that are applicable to equity securities. Under Rule 101 of Regulation M, nonconvertible preferred securities that are rated by at least one NRSRO are exempt from the prohibition on distribution participants and affiliated purchasers

---

[16] *See* Columbus Southern Power Co., SEC No-Action Letter (pub. avail. Jan. 7, 1992) (providing no-action relief allowing issuer to use summary Forms 10-K and 10-Q despite the issuer's preferred securities being held by multiple entities based on representation in request letter that preferred securities should be treated as debt because they share many characteristics with debt instruments).

[17] Exchange Act Rel. No. 42201 (Dec. 3, 1999).

[18] Exchange Act Rel. No. 49148, 2004 WL 184973, at *46 (Jan. 29, 2004).

from bidding for, purchasing or inducing purchases of covered securities during the restricted period.[19] In both Rule 144(a)(4) under the Securities Act of 1933 and Rule 902 of Regulation S, the SEC included "non-participatory preferred stock" in the definition of "debt securities."[20]

The SEC has also granted exemptive relief or the staff has issued no-action guidance from equity rules for entities effecting transactions in preferred securities because of the debt-like characteristics of some preferred securities. In addressing the classification of preferred securities for purposes of Regulation NMS, the SEC recognized that based on the similarity between nonconvertible preferred securities and debt instruments, preferred securities should not be treated as equities. Specifically, the SEC granted an exemption under Regulation NMS because it "recognized the similarities between nonconvertible preferred securities and fixed income instruments, and, in doing so, has treated nonconvertible preferred securities differently than common stock."[21] In the context of the tender offer rules,[22] the SEC staff also recognized that preferred securities have characteristics of debt including that preferred securities are "valued by investors on the basis of their yield, tak[e] into account the issuer's credit spread compared to a benchmark yield, and the yield . . . fluctuates in response to changes in prevailing interest rates."[23] Based on this recognition, the staff determined that its previous no-action relief for debt securities should be applicable to preferred securities.[24]

We believe there is also regulatory flexibility provided by the definitional sections of the Exchange Act and FINRA's rulebook. The preamble of Section 3 of the Exchange Act states that the definitions in the section, including the definition of "equity security," apply "unless the context otherwise requires."[25] Similarly, FINRA Rule 160 states that the definitions in the FINRA rulebook apply "unless the context of the term within a Rule requires a different meaning."[26] This provision has been interpreted by the FINRA staff to provide the necessary flexibility to interpret the definition of a term differently in a particular context in order to further the purpose of that rule.[27] In this case, FINRA could permit members to continue reporting

[19] 17 C.F.R. §242.101(c)(2).

[20] 17 C.F.R. §230.144(a)(4); 17 C.F.R. §230.902(a)(1).

[21] Exchange Act Rel. No. 57621 (Apr. 4, 2008) (exempting preferred securities from Rule 611 of Reg. NMS).

[22] 17 C.F.R. §240.17e-1.

[23] BBVA Privanza International (Gibraltar) Limited and Banco Bilbao Vizcaya Argentaria, SEC No-Action Letter (pub. avail. Dec. 23, 2005).

[24] *Id*.

[25] 15 U.S.C. §78c(a).

[26] FINRA Rule 160(a).

[27] NASD NTM 03-08 (stating that the FINRA staff interpreted the term "customer," which under the general definitional rule did not include broker-dealers, to include broker-dealers for the purpose of reporting short positions of accounts because such an interpretation fit within the context of the rule). As an alternative to creating a definitional structure specifically for the purpose of trade reporting, SIFMA would be willing to work with FINRA on finding a way to achieve its goals without interfering with longstanding trading conventions.

certain hybrid preferred securities to TRACE by interpreting the term "TRACE Eligible Securities" in the context of hybrid securities include those hybrid preferred securities described in the proposed interpretation below.

Given the precedents identified in this letter, the characteristics that have already been identified by regulators as warranting debt-like treatment and the flexibility available to regulators for interpretations, we propose the following alternative interpretation that effectuates the purposes of market transparency and efficiency and would largely support current market practice for trade reporting purposes:

> For the purposes of trade reporting obligations, preferred securities shall be deemed to be equity securities unless they meet the definition of hybrid preferred securities which shall be TRACE eligible.
>
> For purposes of this interpretation, the term "hybrid preferred securities" means:
>
> (a) Shares of preferred securities of an issuer that have the following characteristics:
>
> 1. That are non-participating;
> 2. That are not convertible into common stock or any class of securities of the issuer that is participating in the profits of the issuer;
> 3. That have a coupon/dividend rate that may be fixed or variable. If the coupon/dividend rate is variable, the formula for determining the coupon/dividend rate may not depend upon the financial performance of the issuer or any of its securities;
> 4. That have no voting rights other than: (i) voting to elect a specified number of directors in the event that the issuer does not declare a fixed specified number of payments, (ii) voting on any adverse amendment to the term of the hybrid security; and (iii) those required by the laws of the jurisdiction of organization of the issuer;
> 5. They may have either a stated maturity date or be perpetual preferred stock;
> 6. They may be callable or non-callable; and
> 7. They may be either cumulative or non-cumulative;
>
> or

(b) any security issued by a vehicle controlling, controlled by or under common control with the issuer or sponsored by the issuer (including trusts or depositary structures), provided that the sole asset that produces the funds to make payments on the security issued is a preferred security with the characteristics set forth in (a) or is a debt obligation of the issuer/sponsor.

V. FINRA's Proposed Interpretation Does Not Provide Sufficient Clarity

In the Proposed Interpretation, FINRA provides guidance for two types of hybrid preferred securities, trust/capital preferred and depositary shares, which can be functionally described as follows:

- **Trust preferred securities:** A company creates trust-preferred securities by issuing subordinated debt to a special-purpose entity, which is usually a trust. The special purpose entity issues the trust preferred securities and uses the company's interest payments on the subordinated debt to fund the payments to the holders of the trust preferred securities.[28]

- **Depositary shares:** A depositary share issuance arise from an issuer depositing a designated number of its own preferred shares - typically with a high liquidation amount for each share (say $250,000 each) into a depositary that subsequently issues preferred shares in smaller denominations (representing fractional interests in the deposited shares) to allow for greater liquidity and to reach a broader investor base. The depositary shares are simply a pass-through: all dividend rights and any voting rights of the underlying preferred stock pass through to the holders of the depositary shares.

These two categories, however, fail to capture the entire hybrid preferred universe. At a minimum, hybrid preferred securities can also be issued directly to investors and not through a trust or depositary structure but still share many of the same debt-like features.

SIFMA surveyed certain of its members and identified approximately 282 hybrid securities (not just hybrid preferred) that were being traded in the U.S. and are considered by investors to be investment alternatives in this yield-based investment sector. Of these 282 hybrid securities, 21 (or 7%) would be considered depositary securities and reported as equities under the Proposed Interpretation. Another 67 (or 24%) of the hybrid preferred securities would be considered capital trust securities and reported as debt securities under the Proposed Interpretation. Also included in the survey were 75 (or 27%) convertible or callable debt securities that are generally recognized as debt under trade reporting rules but have unique

[28] GAO-12-237, *Hybrid Capital Instruments and Small Institution Access to Capital*, pg. 8 (Jan. 2012), http://www.gao.gov/assets/590/587759.pdf.

characteristics that cause investors to refer to them as hybrids. The remaining 119 (or 42%) hybrid and hybrid preferred securities that SIFMA identified fit within 3 different categories. These additional categories are not directly addressed by the Proposed Interpretation:

- 32 offerings where the hybrid preferred security is offered directly to the investor or a preferred security is placed into a trust (as opposed to a depository) and the trust issues a hybrid preferred security which may or may not be callable.
- 82 perpetual debt securities - instruments that pay interest, but do not have a maturity date.
- 5 preferred securities that have a mandatory conversion to common stock after a specified period of time as a mechanism to incent the issuer to redeem the securities.

The Proposed Interpretation fails to consider these additional forms of hybrid securities for which clarity would be beneficial to ensure consistency of treatment across a wider hybrid marketplace. If FINRA is unwilling or unable to accommodate existing market convention or adopting the definition/interpretation proposed in Section IV, then we believe the Proposed Interpretation should be reconstructed to provide clarity across the broader hybrid securities universe. We suggest an alternative construction as follows:

> For the purposes of trade reporting obligations and unless otherwise stated, hybrid securities shall be deemed to be equity, regardless of the characteristics or form offered to investors, if the security issued by the issuer in a direct issuance is issued by a charter amendment, or the security is issued by a vehicle controlling, controlled by or under common control with the issuer or sponsored by the issuer, provided that the asset that produces the funds to make payments on the security is issued by a charter amendment. In such cases, one must look through the trust or depositary, if one exists, to the nature of the underlying issuance.
>
> Hybrid securities shall be TRACE reportable if the security issued by the issuer in a direct issuance is not an equity security or the security is issued by a vehicle controlling, controlled by or under common control with the issuer or sponsored by the issuer, provided that the sole asset that produces the funds to make payments on the security issued is not an equity security (a security issued by a charter amendment) of the issuer/sponsor.

VI. Market Participants Will Need Sufficient Time to Adjust to Any Changes to Industry Practices Without Disrupting Liquidity

Regardless of which path FINRA determines to follow, the Proposed Interpretation or the steps we suggest in this letter, changes to market practices with respect to trade reporting of hybrid securities will require significant modifications to systems. Without proper implementation and vigorous testing of numerous interdependent systems, the shift of certain hybrid preferred securities from being reported on TRACE to being reported on an equity security trade reporting venue could negatively impact the liquidity of existing securities and discourage new issuances in a critical market for regulatory capital formation for numerous entities, including financial institutions.

SIFMA members would need a significant amount of time, at a minimum one year, to implement changes to trade reporting of hybrid securities. Such systems would need to be designed and tested, including a careful analysis of the dependencies and interdependencies between and among systems internal to any one broker-dealer. For example, data needs and interactions between customer reporting systems, processing of coupon/dividend payments and any relevant corporate actions would need to be analyzed, modified if needed, and tested. Further, any change in trade reporting and front end trading systems would need to be tested for downstream effects on clearance and settlement systems. Finally, because of data flows to trade reporting systems, clearance and settlement systems and systems that provide information to individual customers and to the market generally, there would need to be general agreement among all such market participants on data format and consistency, and, importantly, testing internally and industry-wide to assure seamless functioning before a transition could be affected.

Vendors are a key interdependency to many participants, and vendor ability to adapt systems is a key consideration in an implementation timeline. Many market participants, both investors and broker-dealers, rely on vendor provided systems for pricing, placing orders or otherwise effecting trades, trade reporting, communication to clearinghouses and trade analytics. As an example, the symbols for hybrid preferred securities that are classified as fixed income securities and are set up in a fixed income system, are not systemically connected to equity trade reporting, clearance and settlement systems. For the many firms that use vendors to report hybrid preferred securities trades, reporting such trades as equities may require a manual transfer from a fixed income system to an equity system. Additionally, investors rely on fixed income analytics for valuation and other purposes and such analytics feed off of data, including trade reporting data that has historically been held in the fixed income databases of such vendors. By parsing out trade transparency from this existing infrastructure, a top-down review must be done to ensure that data feeds can access trade reporting and security profiles in a seamless manner. If vendors are not allowed sufficient time to modify and test systems, customers and broker-dealers that rely on these systems may not be able to participate in the market, likely negatively impacting liquidity.

Asset servicing departments at clearing agencies and custodians will also need to engage in significant systems modifications as well. From our discussions with these entities, we believe it will take significant time for these entities to program their systems to account for any changes in the trade reporting of hybrid preferred securities, including ensuring that corporate actions with respect to these securities continue to be handled properly.[29]

Several other operational factors related to a transition of reporting convention will create the need for sufficient time for implementation. First, we understand that FINRA is migrating reporting of some activity from the Automated Confirmation of Transactions system ("ACT") to ORF. Any migration of the reporting of hybrid preferred securities will need to be incorporated into that timing. Further, including certain hybrid preferred securities in the ORF migration will likely add complexity to an already challenging technology migration. Second, there will need to be agreement among market participants and FINRA on the exact subset of securities subject to a change in TRACE eligibility, the timing and method of migration, and any needed informational changes, such as new CUSIP numbers. Third, as a part of maintaining sound internal controls, many firms freeze technology testing and roll-outs to production during parts of November and all of December and January. For many SIFMA members, that period is rapidly approaching. Finally, Technology resources are already severely constrained within most firms, and backlogs exist in the implementation schedules for a succession of new regulatory-driven projects, many of which have been extended due to this resource constraint.

We know that FINRA is very familiar with the difficulties of implementing a broad-based technology change. As we are all well aware, the interdependencies among market practices, trading conventions and systems need to be carefully scripted before the actual design and testing of the changes occurs. We believe it is fully consistent with FINRA's investor protection goals, as well as SIFMA members' desire to serve their customers and the issuers that use their services, that this process be seamless. For all of these reasons, we believe that a significant time, at a minimum one year, should be provided to the industry if FINRA proceeds with this or any similar proposal. We however hope that FINRA will take heed of the significant concerns we express in this letter and work with the industry on alternative interpretations and solutions to meet its objectives.

* * * * * * * * *

We appreciate this opportunity to comment on the Proposed Interpretation, and welcome the chance to work with FINRA and have further dialogue concerning the Proposed Interpretation including considering possible alternatives to it. In particular, we look forward to discussing potential alternative interpretations of the term equity security in the context of the trade reporting rules. Were FINRA to determine that a change in reporting venue is required, we would want to discuss timing issues to ensure no market disruption occurs. SIFMA is dedicated to working in concert with the regulators involved in this effort to ensure the viability of this critical and growing market and to ensure clarity in the application of the trade reporting rules to unique products such as hybrid preferred securities. If you have any questions or require

[29] We suggest that FINRA discuss the Proposed Interpretation with the investor community, clearing agencies and custodians for institutional investors to hear directly their concerns with any proposed change.

additional information, or would like to further discuss any of the issues presented herein, please do not hesitate to contact the undersigned at ([redacted] or [redacted]

Sincerely,

Sean Davy

Managing Director, Capital Markets