

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83882; File No. SR-FINRA-2018-032)

August 17, 2018

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 6710 to Modify the Dissemination Protocols for Agency Debt Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 16, 2018, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 6710 to modify the dissemination protocols with respect to Agency Debt Securities.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA requires members to report to the Trade Reporting and Compliance Engine (“TRACE”) transactions in TRACE-Eligible Securities,³ including securities that meet the definition of “Agency Debt Security.”⁴ FINRA disseminates transaction information on Agency Debt Securities and displays either the actual size (volume) of the transaction or a capped amount, depending on whether the security is rated as Investment Grade,⁵ Non-Investment

³ Rule 6710 generally defines a “TRACE-Eligible Security” as: a debt security that is United States (“U.S.”) dollar-denominated and is: (1) issued by a U.S. or foreign private issuer, and, if a “restricted security” as defined in Securities Act Rule 144(a)(3), sold pursuant to Securities Act Rule 144A; (2) issued or guaranteed by an Agency as defined in Rule 6710(k) or a Government-Sponsored Enterprise as defined in Rule 6710(n); or (3) a U.S. Treasury Security as defined in Rule 6710(p). “TRACE-Eligible Security” does not include a debt security that is issued by a foreign sovereign or a Money Market Instrument as defined in Rule 6710(o).

⁴ “Agency Debt Security” generally includes a debt security (i) issued or guaranteed by an Agency as defined in Rule 6710(k); (ii) issued or guaranteed by a Government-Sponsored Enterprise (“GSE”) as defined in Rule 6710(n); or (iii) issued by a trust or other entity that was established or sponsored by a GSE for the purpose of issuing debt securities, where such enterprise provides collateral to the trust or other entity or retains a material net economic interest in the reference tranches associated with the securities issued by the trust or other entity. Rule 6710(n) provides that “Government-Sponsored Enterprise” has the same meaning as defined in 2 U.S.C. § 622(8).

⁵ Rule 6710 provides that “Investment Grade” means “a TRACE-Eligible Security that, if rated by only one nationally recognized statistical rating organization (“NRSRO”), is rated in one of the four highest generic rating categories; or if rated by more than one NRSRO, is rated in one of the four highest generic rating categories by all or a majority of such NRSROs; provided that if the NRSROs assign ratings that are evenly divided between (i) the four highest generic ratings and (ii) ratings lower than the four highest generic ratings, FINRA will classify the TRACE-Eligible Security as Non-Investment Grade for purposes of TRACE. If a TRACE-Eligible Security is unrated, for purposes of TRACE, FINRA may classify the TRACE-Eligible Security as an Investment Grade

Grade,⁶ or is unrated. For transactions in Agency Debt Securities that are either Investment Grade or unrated, FINRA disseminates the actual size of the trade for transactions less than or equal to \$5 million in par value traded, thus providing actual transaction size up to \$5 million, and disseminates “\$5MM+” for trades exceeding \$5 million in par value traded.⁷ For transactions in Agency Debt Securities that are Non-Investment Grade, FINRA disseminates the actual size of the trade for transactions less than or equal to \$1 million in par value, and disseminates “1MM+” for trades exceeding \$1 million in par value traded.⁸

FINRA is proposing to apply a \$5 million dissemination cap to all Agency Debt Securities, regardless of the rating assigned to the security. When adopting the original dissemination caps for Agency Debt Securities, FINRA believed that unrated Agency Debt Securities should default to the \$5 million dissemination cap due to factors such as that they trade more consistently with Investment Grade securities that are subject to the \$5 million dissemination cap. While Non-Investment Grade Agency Debt Securities have been disseminated with the \$1 million dissemination cap, FINRA is not aware of the existence of any Non-Investment Grade Agency Debt Securities other than credit risk transfer securities (“CRTs”), a type of Agency Debt Security issued by Fannie Mae (“Fannie”) and Freddie Mac

security. FINRA will classify an unrated Agency Debt Security as defined in [Rule 6710(l)] as an Investment Grade security for purposes of the dissemination of transaction volume.” See FINRA Rule 6710(h).

⁶ Rule 6710 provides that “Non-Investment Grade” means “a TRACE-Eligible Security that, if rated by only one NRSRO, is rated lower than one of the four highest generic rating categories; or if rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by all or a majority of such NRSROs. Except as provided in paragraph (h), if a TRACE-Eligible Security is unrated, FINRA may classify the TRACE-Eligible Security as a Non-Investment Grade security.” See FINRA Rule 6710(i).

⁷ See Securities Exchange Act Release No. 59733 (April 8, 2009), 74 FR 17709 (April 16, 2009) (Notice of Filing of File No. SR-FINRA-2009-010).

⁸ See supra note 7.

(“Freddie”). Based on experience gained with CRTs and in consultation with Fannie and Freddie, FINRA believes that it is appropriate to disseminate Non-Investment Grade CRTs with the \$5 million dissemination cap. Because CRTs are the only type of Agency Debt Security rated less than Investment Grade, FINRA is proposing to simplify the dissemination structure by applying the \$5 million dissemination cap to all Agency Debt Securities irrespective of rating.

FINRA notes that transactions in the vast majority of securities issued by Fannie and Freddie are disseminated with the actual size of the trade (uncapped), and, of those that are capped, the vast majority are disseminated with the \$5 million cap: 94.4% of all transactions in direct obligations issued by Fannie and Freddie, including CRTs, currently are disseminated with the actual size of the trade. Of the remaining 5.6% that are capped (both at \$1 million and \$5 million), 95% currently are disseminated with the \$5 million cap. Thus, FINRA believes that the proposed modification to apply the \$5 million dissemination cap to all Agency Debt Securities uniformly will have a minimal impact, while simplifying the dissemination structure and providing additional transparency in Agency Debt Securities.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁹ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles

⁹ 15 U.S.C. 78o-3(b)(6).

of trade, and, in general, to protect investors and the public interest. The proposed rule change would benefit investors in that it would simplify the dissemination structure by creating a uniform dissemination protocol for all Agency Debt Securities, and would increase transparency for transactions in Non-Investment Grade Agency Debt Securities over \$1 million. Additionally, the proposed rule change would have a minimal impact as the vast majority of capped transactions in Agency Debt Securities are already disseminated with the \$5 million cap.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how to best meet its regulatory objectives.

Economic Baseline

As of December 31, 2017, there were 35 Investment Grade, 9 Non-Investment Grade, and 172 unrated CRT classes (based on TRACE data). FINRA notes that certain CRTs are currently the only type of Agency Debt Security with a Non-Investment Grade rating. The outstanding amount of these issues are \$770 million, \$350 million and \$2,877 million for Investment Grade, Non-Investment Grade and unrated issues respectively. Table 1 presents the

number of trades reported to TRACE and nominal trade value of CRT CUSIPs by rating for the calendar year beginning January 1, 2017.¹⁰

Table 1

Grade	Trades		Trade Value	
	Number	Percent	Dollars (millions)	Percent
Non-Investment	1,950	13.6%	8,800.9	13.6%
Investment	1,988	13.8%	8,880.1	13.7%
Unrated	10,423	72.6%	47,077.7	72.7%

Under the existing dissemination protocols, Agency Debt Securities that are unrated or rated Investment Grade are disseminated with a \$5 million dissemination cap, where trades over \$5 million are displayed as “5MM+.” Non-Investment Grade Agency Debt Securities are disseminated with a \$1 million dissemination cap, where trades over \$1 million are displayed as “1MM+.” Table 2 presents the number and percent of trades and nominal trade value disseminated with actual trade sizes or displayed with “5MM+” for Investment Grade or unrated CRT CUSIPs for calendar year 2017. These statistics include all trades reported to TRACE during the period, and thus would include two trade reports for interdealer trades and one trade report for dealer to customer trades (two-sided trade data).¹¹

¹⁰ Each CRT deal utilizes a senior/subordinate structure in which credit protection is provided to the senior class by the subordinate classes in priority order. The senior class and subordinate tranches, while part of the same CRT issuance, are separate securities and each are assigned a unique CUSIP. In addition, each CRT class can be further tranching to provide additional optionality for investors’ needs. As such, each CRT class is associated with multiple unique CUSIPs. We note that only the CUSIP associated with the senior tranche contributes to the amount of debt outstanding for a given CRT class.

¹¹ For calendar year 2017, there were 11,341 trades reported to TRACE, that include only one trade report for interdealer trades and one trade report for dealer to customer trades (one-sided trade data), in Investment Grade and unrated CRT CUSIPs, of which 20.8% were displayed as “5MM+.”

Table 2

Grade	Trades			
	≤\$5M		>\$5M	
	Number	Percent	Number	Percent
Investment	1,524	76.7%	464	23.3%
Unrated	8,435	80.9%	1,988	19.1%
	Trade value			
	≤\$5M		>\$5M	
	Dollars (millions)	Percent	Dollars (millions)	Percent
Investment	2,591.5	29.2%	6,288.6	28.2%
Unrated	22,390.9	47.6%	24,686.7	46.6%

Table 3 presents the number and percent of trades and nominal trade value disseminated with actual trade sizes or displayed with “1MM+” for Non-Investment Grade CRT CUSIPs for calendar year 2017.¹²

Table 3

Grade	Trades			
	≤\$1M		>\$1M	
	Number	Percent	Number	Percent
Non-Investment	222	11.4%	1,728	88.6%
	Trade value			
	≤\$1M		>\$1M	
	Dollars (millions)	Percent	Dollars (millions)	Percent
Non-Investment	139.7	1.6%	8,661.2	98.4%

Economic Impact

Based on transactions during calendar year 2017, this proposal would have led to dissemination of additional trade size information for 1,112 trades in 82 CRT CUSIPs than

¹² For calendar year 2017, there were 1,712 trades reported to TRACE, that include only one trade report for interdealer trades and one trade report for dealer to customer trades (one-sided trade data), in Non-Investment Grade CUSIPs, of which 88.3% were displayed as “1MM+.”

disseminated under the current protocols. This increased transparency could have impacts on investors, market makers and issuers. Markets participants, especially uninformed investors, generally anticipate that they benefit from greater price transparency because, in the presence of this information, they are more likely to gain more timely information about the current price of an asset. Knowing this, they may be more willing to commit capital.¹³

At the same time, FINRA understands that some firms believe that transparency about the size of larger trades impedes their ability to commit capital and hence may have a negative impact on liquidity. Increasing transparency may increase the amount of information available to uninformed investors on transaction size and price. This may reduce the informed investors' relative advantage by decreasing the bid-ask spread earned by an informed investor or increasing the bid-ask spread paid by an informed investor. Furthermore, firms may be less willing to trade as principal and hold these securities in inventory, leading to wider spreads or less depth, if they fear that investors may identify the firms' inventory position.¹⁴ In addition, existing institutional investors that prefer trading in large sizes or at the current level of transparency in Non-Investment Grade CRTs may substitute trading in other asset classes, if the investors fear others may identify their holdings. The consensus of the academic literature studying the impact of transparency in a variety of settings in U.S. fixed income markets is that greater transparency is associated with lower costs to end customers and positive to neutral impacts on market

¹³ For instance, one study that examined corporate bond transactions in TRACE from January 2003 through January 2005 found that “[c]osts are lower for bonds with transparent trade prices, and they drop when the TRACE system starts to publicly disseminate their prices. The results suggest that public traders benefit significantly from price transparency.” For additional details, see Amy K. Edwards, Lawrence E. Harris, and Michael S. Piwowar, Corporate Bond Market Transaction Costs and Transparency, *Journal of Finance* 62, No. 3, 1421-1451 (2007).

¹⁴ See supra note 13.

liquidity.¹⁵ In addition, FINRA has discussed the proposed rule change with Fannie and Freddie, both of which support the application of the \$5 million dissemination cap to all CRTs.

Alternatives

No alternatives are under consideration.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2018-032 on the subject line.

¹⁵ See supra note 13.

Paper comments:

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

All submissions should refer to File Number SR-FINRA-2018-032. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make

available publicly. All submissions should refer to File Number SR-FINRA-2018-032, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶

Eduardo A. Aleman
Assistant Secretary

¹⁶ 17 CFR 200.30-3(a)(12).