

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71629; File No. SR-FINRA-2013-039)

February 27, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc; Notice of Filing of Amendment No. 1 to Proposed Rule Change to Clarify the Classification and Reporting of Certain Securities to FINRA

I. Introduction

On September 16, 2013, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to clarify the classification and reporting of certain securities to FINRA. The proposed rule change was published for comment in the Federal Register on September 30, 2013.³ The Commission received two comments on the proposal.⁴ On November 12, 2013, FINRA granted the Commission an extension of time to act on the proposal until December 29, 2013.

On December 24, 2013, the Commission instituted proceedings to determine whether to disapprove the proposed rule change.⁵ On February 12, 2014, FINRA submitted Amendment No. 1 to respond to the comment letters and amend the proposed rule change, as described below in Item II, which Item has been prepared by FINRA. The Commission is publishing this notice

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 70482 (September 23, 2013), 78 FR 59995 (September 30, 2013) (“Notice”).

⁴ See Letters to the Commission from Sean Davy, Managing Director, Capital Markets, SIFMA, dated October 21, 2013 (“SIFMA Letter”); and Manisha Kimmel, Executive Director, Financial Information Forum, dated October 31, 2013 (“FIF Letter”).

⁵ See Securities Exchange Act Release No. 71180 (December 24, 2013), 78 FR 79716 (December 31, 2013).

to solicit comment from interested persons on the proposed rule change, as modified by Amendment No. 1.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change, as Modified by Amendment No. 1

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 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 Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA trade reporting rules generally require that members report over-the-counter (“OTC”) transactions in debt securities that are “TRACE-Eligible Securities”⁶ and equity securities to FINRA.⁷ FINRA Rule 6622 (Transaction Reporting) requires that members report OTC transactions in “OTC Equity Securities”⁸ to the ORF and the FINRA Rule 6700 Series

⁶ FINRA Rule 6710(a) defines “TRACE-Eligible Security” to include “a debt security that is United States (‘U.S.’) dollar-denominated and 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.”

⁷ See FINRA Rules 6282 (relating to the Alternative Display Facility (“ADF”)), 6380A (relating to the FINRA/Nasdaq Trade Reporting Facility), 6380B (relating to the FINRA/NYSE Trade Reporting Facility), 6622 (relating to the OTC Reporting Facility (“ORF”)) and 6730 (relating to the Trade Reporting and Compliance Engine (“TRACE”)).

⁸ FINRA Rule 6420(f) defines “OTC Equity Security” to include “any equity security that is not an ‘NMS stock’ as that term is defined in Rule 600(b)(47) of SEC Regulation NMS; provided, however, that the term ‘OTC Equity Security’ shall not include any Restricted Equity Security.” FINRA Rule 6420(k) defines “Restricted Equity Security”

requires members to report transactions in TRACE-Eligible Securities to TRACE.

FINRA recently has received inquiries regarding the appropriate classification of certain “hybrid” securities for trade reporting purposes. FINRA is aware that as new securities are created and issued, in some cases, the newer hybrid iteration, although derived from a traditional security, may be increasingly complex, and may have both debt and equity-like features. These hybrid securities are frequently designed to straddle both classifications for a variety of purposes, including the tax treatment applicable to issuers and recipients when distributions are made (or not made) to holders of the security, and the treatment of the principal as capital for issuers subject to capital requirements. As such, determining whether these hybrid securities should be treated as an OTC Equity Security or a TRACE-Eligible Security for purposes of trade reporting to the appropriate FINRA facility has become less clear.

Given the complexity of these hybrid securities, FINRA proposed an interpretation regarding the classification and reporting of two categories of hybrid securities (capital trust securities (also referred to as trust preferred securities) and certain depositary shares) to clarify the appropriate trade reporting facility to which such securities should be reported.⁹ In addition,

to mean “any equity security that meets the definition of ‘restricted security’ as contained in Securities Act Rule 144(a)(3).”

⁹ The proposed interpretation applies solely to a hybrid security that is not listed on an equity facility of a national securities exchange. See, e.g., FINRA Trade Reporting Notice, February 22, 2008 (FINRA applied TRACE reporting requirements, distinguishing between listed and unlisted securities, and required members to report transactions in unlisted convertible debt and unlisted equity-linked notes to TRACE, and OTC transactions in convertible debt and equity-linked notes listed on an equity facility of a national securities exchange to an appropriate FINRA equity trade reporting facility for NMS Stocks (the ADF or a trade reporting facility (“TRF”)). For purposes of this proposed rule change, the term “listed on an equity facility of a national securities exchange” means a security that qualifies as an NMS stock (as defined in Rule 600(b)(47) of Regulation NMS under the Act) as distinguished from a security that is listed on a bond facility of a national securities exchange. See 17 CFR 242.600(b)(47).

FINRA proposed a policy to address the treatment of securities that are currently being reported to a facility that is not the designated facility under this interpretation.

Comments Received

On September 30, 2013, the SEC published the proposed rule change for comment in the Federal Register.¹⁰ The SEC received two comment letters in response to the proposed rule change, both of which raised concerns with certain aspects of the proposal.¹¹ Both commenters indicated that the vast majority of hybrid securities identified in the interpretation are traded by their members as fixed income securities.¹² In particular, SIFMA noted that hybrid securities with a par value of \$1,000 or more have historically been traded and settled with a debt convention¹³ as such securities traded on the basis of yield and credit quality and, similarly, investors evaluated them based on their debt-like characteristics, such as yield, time to first call, credit rating and priority in the capital structure in that they are paid after other debt but before common equity. Thus, commenters indicated that reporting such securities to TRACE better accommodates and is consistent with these debt trading conventions.

Given that these securities have historically traded and been reported as debt, the

¹⁰ See Securities Exchange Act Release No. 70482 (September 24, 2013), 78 FR 59995 (September 30, 2013) (Notice of Filing of Proposed Rule Change To Clarify the Classification and Reporting of Certain Securities to FINRA; File No. SR-FINRA-2013-039).

¹¹ See Letter from Sean Davy, Managing Director, Capital Markets, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated October 21, 2013 (“SIFMA”) and letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth M. Murphy, Secretary, SEC, dated October 31, 2013 (“FIF”).

¹² See SIFMA and FIF.

¹³ In general, trading with a debt convention includes counterparties discussing the notional amount of the security, its price and the carried accrued interest that is expressed separately from the price. However, SIFMA acknowledged that securities with par value less than \$1,000 generally trade as equity securities in an equity format.

commenters raised many concerns about the significant disruption to fixed income trading work flows that would result if these securities were reported to the ORF, in light of the interdependencies among trading systems, including the operational and technology changes and costs associated therewith. Commenters highlighted a variety of potential downstream impacts of reporting depository shares to ORF¹⁴ and questioned whether the benefits of the proposal outweigh the costs.¹⁵

SIFMA raised similar concerns emphasizing that the hybrid securities market is a critical part of the capital markets, noting that many of these securities are being issued by financial institutions to satisfy equity capital requirements as part of the International Regulatory Framework for Banks developed by the Bank for International Settlements, known as Basel III. SIFMA indicated that a shift in the market practice for these securities could create investor confusion in the market. SIFMA argues that investors, institutional investors in particular, use the debt trading analytics as a critical part of their investment decisions and any change to the practice could in turn negatively impact liquidity. Further, SIFMA emphasized that there is regulatory precedent to permit the subject securities to be reported to TRACE and would be consistent with conclusions reached by the Commission in other contexts with respect to non-convertible preferred securities that may be classified or treated as debt securities.¹⁶ SIFMA also

¹⁴ For example, FIF noted potential impact relating to Section 31 fees, TAF fees, Electronic Blue Sheets, INSITE reporting, short interest, beneficial ownership, order ticket, confirmations, corporate actions and tax treatment.

¹⁵ See FIF. SIFMA also encouraged FINRA to consider more cost effective alternatives, including making changes to its trade reporting systems that would accomplish its goals without imposing undue burdens on the market.

¹⁶ See Securities Exchange Act Release No 57621 (April 4, 2008), 73 FR 19270 (April 9, 2008) (Order Exempting Non-Convertible Preferred Securities from Rule 611(a) of Regulation NMS under the Securities Exchange Act of 1934). See also Rule 144(a)(4) and Rule 902 of Regulation S under the Securities Act of 1933 wherein “non-participatory preferred stock” is included in the definition of “debt securities”.

expressed its belief that the proposal does not address the full spectrum of hybrid securities and the classification should provide further clarity and guidance in anticipation of further market developments. Regardless of the ultimate reporting venue, SIFMA indicated at least one year is needed to implement any necessary changes.

Response to Commenters

After careful consideration of the comments, FINRA acknowledges that the appropriate classification of hybrid securities is a complex analysis that has important consequences. FINRA agrees with the commenters that hybrid securities, in particular securities with a liquidation preference of \$1,000 or more, do indeed have significant debt-like characteristics, as noted by SIFMA, that were created to “mix and match both debt and equity characteristics to achieve the particular tax, regulatory capital and rating agency treatment needs of the issuer” and “is an important source of bank regulatory capital.” As such, given the multi-faceted nature of these products, FINRA believes all aspects of these products should be given consideration in evaluating the proper classification for trade reporting purposes. In this regard, FINRA further discussed the proposal with several institutional investor representatives who also agreed with the concerns raised by commenters of potential unintended downstream impact if these securities were not reported to TRACE.

Given the consistent view throughout the industry, FINRA believes it is appropriate to treat these securities as debt for purposes of trade reporting. Accordingly, FINRA proposes to modify its original interpretation to provide that, in addition to capital trust and trust preferred securities, the term TRACE-Eligible Security includes: (1) a depositary share having a liquidation preference of \$1,000 or more (or a cash redemption price of \$1,000 or more) that is a

fractional interest in a non-convertible,¹⁷ preferred security and is not listed on an equity facility of a national securities exchange (“hybrid \$1,000 depositary share”); and (2) a non-convertible, preferred security having a liquidation preference of \$1,000 or more (or a cash redemption price of \$1,000 or more) that is not listed on an equity facility of a national securities exchange (“hybrid \$1,000 preferred security”), such as a hybrid \$1,000 preferred security that is offered directly to an investor or a preferred security underlying multiple hybrid \$1,000 depositary shares.¹⁸ Any such security deemed as a TRACE-Eligible Security would be excluded from the defined term OTC Equity Security.

FINRA believes that consistency in the market practice and maintaining the established securities transaction information flow to investors is important and furthers the highly developed reporting and transparency infrastructure already in place to which the marketplace and investors are accustomed. FINRA believes that the TRACE system better accommodates the debt trading and reporting conventions of these securities and investors will be able to more reliably and efficiently find market information about these securities, consistent with how they access information for products that trade based on similar characteristics, e.g., yield and credit quality.

FINRA believes this amended interpretation will prevent investor confusion by allowing

¹⁷ Non-convertible means not convertible into or exchangeable for property or shares of any other series or class of the issuer’s capital stock.

¹⁸ FINRA is not modifying its previously filed interpretation regarding the treatment of capital trust securities and trust preferred securities. Specifically, the term TRACE-Eligible Security includes capital trust securities and trust preferred securities (other than a capital trust security or a trust preferred security that is listed on an equity facility of a national securities exchange) and transactions in such securities must be reported to TRACE (and not to ORF) in compliance with the applicable reporting requirements. This interpretation would apply even if the capital trust security (or a trust preferred security) was previously listed on an equity facility of a national securities exchange and reported to a FINRA equity facility, but has since been delisted. Once delisted, the security must be reported to TRACE.

hybrid \$1,000 depositary shares and hybrid \$1,000 preferred securities to be reported to TRACE. Since the reporting determination is an important factor in driving certain downstream activities, such as clearing and settling such securities and the reporting data used by investors and other market participants, FINRA believes the proposed amended interpretation preserves the established market practice for these securities and achieves investor protection goals consistent with the debt-like nature of the security, without being unduly burdensome and requiring significant technological changes. As raised by SIFMA, FINRA also believes the revised interpretation is consistent with conclusions reached by the Commission in other contexts with respect to non-convertible preferred securities that may be classified or treated as debt securities.¹⁹

While it is impossible to address all future types of securities, as it frequently is a security-specific fact-based analysis, FINRA believes that the expansion of the proposed interpretation to address additional forms of hybrid securities will address a significant portion of the market and adapt to future offerings. FINRA endeavors to continue to work directly with SIFMA, FIF and all market participants to ensure consistent reporting treatment across the hybrid securities market. Further, FINRA believes the modified interpretation set forth above provides sufficient detail and guidance for members to ensure accurate reporting to the appropriate trade reporting facility.

In light of the expanded and modified interpretation discussed above, FINRA declines to extend the implementation date beyond the originally proposed maximum of 150 days following Commission approval. FINRA believes that the modified interpretation largely follows current market practice and accordingly anticipates that members will be able to comply within such

¹⁹ See note 14.

timeframe.

Other Preferred Securities and Depositary Shares

All other preferred securities and depositary shares representing fractional interests in such securities except the hybrid securities identified above – hybrid \$1,000 preferred securities and hybrid \$1,000 depositary shares - will continue to be included in the defined term OTC Equity Security, and members must report transactions in such securities to ORF. For example, a non-convertible preferred security having a par value or liquidation preference of \$25 that is not listed on an equity facility of a national securities exchange would be an OTC Equity Security under the interpretation and would be required to be reported to ORF.²⁰ When reporting to ORF is required, members must report in accordance with ORF requirements. For example, price should be reported as the dollar price per share and volume should be reported as the number of preferred shares traded.

Hybrid Securities Currently Being Reported to ORF and TRACE

As noted in the original proposal, FINRA believes that, given the complexity of many of the securities that are the subject of this proposed rule change, it is reasonable that firms, despite their best efforts, may have reached different conclusions on where transactions in these hybrid securities should be reported. FINRA proposes that, as of the implementation date of this proposed rule change, securities that are affected by this amended proposed interpretation will be transferred, if necessary, for reporting to the appropriate trade reporting facility, and after this transfer members must report all transactions in such securities to the appropriate trade reporting facility. Members will not be required to retroactively cancel and correct any transactions in

²⁰ Under this interpretation, members must request a symbol, if one has not already been assigned, for such preferred shares for ORF reporting in compliance with the applicable reporting requirements.

such securities previously reported to a facility that is not the designated facility under this interpretation. Thus, members will not be required to cancel and correct transactions in capital trust securities reported to the ORF or transactions in preferred securities and depositary shares reported to TRACE (excluding hybrid \$1,000 preferred securities and hybrid \$1,000 depositary shares) prior to the implementation date of this proposed rule change.²¹ However, if a firm reported a transaction to the facility designated in this proposed interpretation, but did not report in accordance with the applicable trade reporting requirements of that facility (e.g., a firm reported a transaction to ORF, but inaccurately reported the price or size as if reporting to TRACE), the firm will be required to cancel and re-report such transactions accurately.

FINRA will publish the interpretation and its implementation date in a Regulatory Notice no later than 60 days following Commission approval. The implementation date will be no later than 90 days following publication of the Regulatory Notice announcing Commission approval.

²¹ Pursuant to Section 31 of the Act, FINRA and the national securities exchanges are required to pay transaction fees and assessments to the SEC that are designed to recover the costs related to the government's supervision and regulation of the securities markets and securities professionals. See 15 U.S.C. 78ee. FINRA obtains its Section 31 fees and assessments from its membership, in accordance with Section 3 of Schedule A to the FINRA By-Laws. The transactions that are assessable under Section 3 of Schedule A to the FINRA By-Laws are reported to FINRA through one of FINRA's equity trade reporting facilities: the ORF, the ADF, or a TRF. As expressly stated in the Act, sales of bonds, debentures, or other evidence of indebtedness (debt securities) are excluded from Section 31 of the Act. See 15 U.S.C. 78ee(b). Because of this exclusion under Section 31 of the Act, transactions reported to TRACE are not subject to the regulatory transaction fee under Section 3 of Schedule A to the FINRA By-Laws. To determine whether a non-exchange listed security is an equity security or a debt security for purposes of assessing the regulatory transaction fee, FINRA relies on the facility to which the transaction is reported. If the transaction is reported to the ORF, the transaction is treated as one involving an equity security and is subject to the regulatory transaction fee. If the transaction is reported to TRACE, the transaction is treated as one involving a debt security and thus is not subject to the regulatory transaction fee. See Regulatory Notice 08-72 (December 2008).

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²² 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 of trade, and, in general, to protect investors and the public interest. FINRA believes that by clarifying the classification of certain hybrid securities that are not listed on an equity facility of a national securities exchange for reporting purposes, the proposed rule change will reduce market and investor confusion. In addition, FINRA believes that the proposed rule change will improve transparency significantly because members will report transactions in the same security using a uniform set of conventions and to the same facility (i.e., the ORF or TRACE). This will allow investors and other market participants to better compare transaction pricing and the quality of their executions, which promotes just and equitable principles of trade, deters fraudulent and manipulative acts and practices in the market for such securities, and furthers the protection of investors and the public interest.

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

FINRA does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Members that are required currently to report transactions in hybrid securities will continue to be subject to transaction reporting requirements and will be provided clarity as to which facility such hybrid securities should be reported, which will promote uniformity and consistency in trade reporting within these categories of products.

²² 15 U.S.C. 78q-3(b)(6).

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

On September 30, 2013, the Commission published the proposed rule change for comment in the Federal Register.²³ The comment period closed on October 21, 2013. The Commission received two comment letters in response to the proposed rule change.²⁴ On December 24, 2013, the Commission published an order to institute proceedings pursuant to Section 19(b)(2)(B) of the Act²⁵ to determine whether to disapprove the proposed rule change.²⁶ No other comments were received by the Commission. A summary of the comments received and FINRA's response are provided above in Item 3 of this filing.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 1, 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-2013-039 on the subject line.

²³ See note 8.

²⁴ See note 9.

²⁵ 15 U.S.C. 78s(b)(2)(B).

²⁶ See Securities Exchange Act Release No. 71180 (December 24, 2013), 78 FR 79716 (December 31, 2013) (Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Change to Clarify the Classification and Reporting of Certain Securities to FINRA).

Paper comments:

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

All submissions should refer to File Number SR-FINRA-2013-039. 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 changes that are filed with the Commission, and all written communications relating to the proposed rule changes 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 the filing also will be available for inspection and copying at principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File

Number SR-FINRA-2013-039 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.²⁷

Kevin M. O'Neill
Deputy Secretary

²⁷ 17 CFR 200.30-3(a)(12).