

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71927; File No. SR-FINRA-2013-039)

April 10, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Clarify How Certain Securities Are Classified and Reported 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 how certain securities are classified and reported 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 Original 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 comments and amend the proposed rule change, which the Commission

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) (“Original Proposal”).

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) (“Order Instituting Proceedings”).

published for comment in the Federal Register on March 5, 2014.⁶ In response to the Order Instituting Proceedings and the Notice of Amendment No. 1, the Commission received one additional comment letter on the proposal.⁷ On March 27, 2014, the Commission extended to May 28, 2014, the period for Commission action to determine whether to disapprove the proposed rule change, as modified by Amendment No. 1.⁸

This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Original Proposal

FINRA's rules generally require that members report over-the-counter ("OTC") transactions in eligible debt and equity securities to a trade reporting system operated by FINRA. FINRA Rule 6622 requires that members report transactions in OTC Equity Securities⁹ to the OTC Reporting Facility ("ORF"), and the Rule 6700 Series requires members to report transactions in TRACE-Eligible Securities¹⁰ to the Trade Reporting and Compliance Engine ("TRACE").

⁶ See Securities Exchange Act Release No. 71629 (February 27, 2014), 79 FR 12541 (March 5, 2014) ("Notice of Amendment No. 1").

⁷ See Letter to the Commission from Sean Davy, Managing Director, Capital Markets, SIFMA, dated March 14, 2014 ("SIFMA Letter II").

⁸ See Securities Exchange Act Release No. 71819 (March 27, 2014), 79 FR 18591 (April 2, 2014).

⁹ 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" to mean "any equity security that meets the definition of 'restricted security' as contained in Securities Act Rule 144(a)(3)."

¹⁰ 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."

The Original Proposal was designed to clarify how members are required to report two classes of securities—“depository shares” and “capital trust” (or “trust preferred”) securities—under these rules. Both classes are “hybrid” securities, in that each has debt- and equity-like features. According to FINRA, such 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.¹¹ In the Original Proposal, FINRA stated that it had received requests for guidance whether such hybrid securities should appropriately be classified as equities, and thus reported to ORF, or debt securities, and thus reported to TRACE.

FINRA thus proposed to classify depository shares, when not listed on an equity facility of a national securities exchange,¹² as OTC Equity Securities under FINRA Rule 6420(f). As such, depository shares would be reportable to ORF in accordance with ORF requirements. FINRA took the view that depository shares generally are securities that represent a fractional interest in a share of preferred stock, and preferred stocks are considered equity securities. FINRA noted further that depository shares generally entitle the holder, through the depository, to a proportional fractional interest in the rights, powers, and preferences of the preferred stock represented by the depository share.¹³

¹¹ See Original Proposal, 78 FR at 59996.

¹² For purposes of the proposed rule change, the term “listed on an equity facility of a national securities exchange” would mean a security that qualifies as an NMS stock (as defined in Rule 600(b)(47) of Regulation NMS) as distinguished from a security that is listed on a bond facility of a national securities exchange.

¹³ See Original Proposal, 78 FR at 59996.

With respect to capital trust (or trust preferred) securities, FINRA proposed to include such securities within the definition of “TRACE-Eligible Security” under FINRA Rule 6710(a). Thus, members would be required to report transactions in such securities to TRACE according to applicable TRACE reporting requirements. For example, members would be required to report price as a percentage of par value, and volume as the total par value of the transaction (not the number of bonds traded).¹⁴

FINRA stated that the proposed interpretation would apply only on a prospective basis. It would not require FINRA members to review old trades and cancel and re-report those trades if they had been reported contrary to the terms of the proposal. If the proposal became effective, FINRA members would be required to cancel and re-report trades that occurred after the date of the proposal’s effectiveness only if those trades had been reported incorrectly.¹⁵

III. Comments on the Original Proposal, FINRA’s Response, and Amendment No. 1

Summary of Comments. As noted above, the Commission received two comment letters on the Original Proposal.¹⁶ Both comments expressed concern with FINRA’s proposed guidance regarding trade reporting of hybrid securities, and argued that hybrid securities currently being reported to TRACE should continue to be reported to TRACE. One of the commenters stated, in particular, that investors evaluate hybrid securities, including depositary shares, based upon their fixed income attributes. According to this commenter, depositary shares with a par value of \$1,000 have historically been traded and settled with a debt convention, meaning on the basis of

¹⁴ See FINRA Rule 6730.

¹⁵ See Original Proposal, 78 FR at 59996-97.

¹⁶ See supra note 4.

yield and credit quality rather than on the potential for capital appreciation.¹⁷ This commenter supported the current market practice of treating depositary shares with \$1,000 par value or greater as debt securities. The commenter believed that the proposed interpretation could dampen the secondary market by creating investor confusion or rendering the securities ineligible for inclusion in fixed income indices.¹⁸

Both commenters argued that it would be difficult for market participants to adapt their systems to comply with the proposed reclassification of depositary shares as ORF-eligible. One commenter noted that the data fields captured by FINRA’s ORF are different than those captured by TRACE.¹⁹ The second commenter stated that many firms have separate trading, operations, and technology architecture for equities and debt that is tailored to the order lifecycle of each type of instrument,²⁰ and argued that the costs of implementing the new guidance may not justify the benefits.²¹

One of the commenters also believed that the proposed guidance “fail[ed] to capture the entire hybrid preferred universe,”²² and therefore offered a formulation of the guidance that it believed would more thoroughly define the criteria by which a security would be classified as reportable to ORF or TRACE.²³

¹⁷ See SIFMA Letter at 6. See also FIF Letter at 1 (stating generally that the depositary shares “are traded as fixed income securities”).

¹⁸ See SIFMA Letter at 5.

¹⁹ For example, ORF collects for each transaction the price per share and number of shares traded. It does not have a data field for an accrued coupon or dividend, information captured as part of debt transactions reported to TRACE. See *id.* at 7.

²⁰ See FIF Letter at 1-2. This commenter also listed a number of other potential effects of the proposed interpretation. See *id.* at 2-3.

²¹ See *id.* at 3.

²² SIFMA Letter at 11.

²³ See *id.* at 12.

FINRA's Response to Commenters and Amendment No. 1. FINRA acknowledged that the appropriate classification of hybrid securities is a complex analysis and agreed with the commenters that hybrid securities—in particular, securities with a liquidation preference of \$1,000 or more—have significant debt-like characteristics. FINRA stated that it had further discussions about the proposal with several institutional investors who, in general, agreed with the concerns raised by the commenters.²⁴

Therefore, in Amendment No. 1, FINRA modified the proposed interpretation to provide that, in addition to capital trust and trust preferred securities, the term “TRACE-Eligible Security” would include: (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,²⁵ 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. Any such security deemed as a TRACE-Eligible Security would be excluded from the term “OTC Equity Security.”²⁶

FINRA did not modify the proposed interpretation regarding the treatment of capital trust securities and trust preferred securities. Thus, the term “TRACE-Eligible Security” would

²⁴ See Notice of Amendment No. 1, 79 FR at 12543.

²⁵ “Non-convertible” means not convertible into or exchangeable for property or shares of any other series or class of the issuer’s capital stock. See Notice of Amendment No. 1, 79 FR at 12543, n. 17.

²⁶ See Notice of Amendment No. 1, 79 FR at 12543.

include a capital trust security and a trust preferred security (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 but has since been delisted. Once delisted, the security must be reported to TRACE.²⁷ 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—would continue to be included in the term “OTC Equity Security,” and members must report transactions in such securities to ORF.²⁸

In light of the amended interpretation, FINRA determined not to extend the implementation date beyond the originally proposed maximum of 150 days following Commission approval. FINRA believes that members will be able to comply within such timeframe because the amended interpretation largely follows current market practice.²⁹ Therefore, as of the date of implementation, affected securities 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.

²⁷ See id. at n. 18.

²⁸ 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. See 79 FR at 12543.

²⁹ See id.

Comment on Amendment No. 1. The Commission received one comment letter in response to Amendment No. 1.³⁰ The commenter supported the proposed revisions and believed that the amended interpretation would prevent investor confusion by allowing hybrid \$1,000 depositary shares and hybrid \$1,000 preferred securities to be reported to TRACE. The commenter stated that the amended interpretation “appropriately 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.”³¹

V. Discussion

After carefully considering the proposed rule change, as modified by Amendment No. 1, the comments submitted, and FINRA’s response to the comments, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.³² In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the Act,³³ which requires, among other things, that FINRA rules 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.

The Commission believes that it is reasonable and consistent with the Act for FINRA to provide guidance as to whether particular hybrid securities should, for purposes of FINRA’s trade reporting rules, be deemed debt securities, and thus TRACE-eligible, or equity securities,

³⁰ See supra note 7.

³¹ SIFMA Letter II at 2.

³² In approving this proposed rule change, the Commission has considered the proposed rule change’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³³ 15 U.S.C. 78o-3(b)(6).

and thus reportable to an equity trade reporting facility. Although such securities may have both debt and equity features, the Commission believes that it is appropriate for FINRA to seek to address the confusion about how to report such securities by having all transactions in a particular type of hybrid security reported to the same facility. This approach is reasonably designed to promote transparency, as all trade reports of the same hybrid security discussed in the proposal should now be reported to and disseminated by the same trade reporting facility, instead of appearing on different facilities in different formats. Furthermore, the Commission believes that, in the absence of a compelling regulatory reason to require hybrid securities to be reported to an equity trade reporting facility such as the ORF, it is consistent with the Act for FINRA to permit its members to continue using existing infrastructure to report the hybrid securities in question to TRACE.

VII. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act³⁴ that the proposed rule change (SR-FINRA-2013-039), as modified by Amendment No. 1, be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁵

Jill M. Peterson
Assistant Secretary

³⁴ 15 U.S.C. 78s(b)(2).

³⁵ 17 CFR 200.30-3(a)(12).