

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-70482; File No. SR-FINRA-2013-039)

September 24, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Clarify the Classification and Reporting of Certain Securities to FINRA

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 16, 2013, 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 filing a proposed rule change to adopt an interpretation to clarify the classification and the reporting of certain securities to FINRA.

The proposed rule change does not make any changes to the text of FINRA rules.

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

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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 and equity securities to FINRA.<sup>3</sup> FINRA Rule 6622 requires that members report OTC transactions in “OTC Equity Securities”<sup>4</sup> to the ORF and the FINRA Rule 6700 Series requires members to report transactions in “TRACE-Eligible Securities” to TRACE.<sup>5</sup>

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

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<sup>3</sup> 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”)).

<sup>4</sup> 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).”

<sup>5</sup> 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.”

subject to capital requirements. As such, determining whether these hybrid securities should be classified as “debt” or “equity” for purposes of trade reporting to the appropriate FINRA facility has become less clear.

Given the complexity of these hybrid securities, FINRA proposes an interpretation regarding the classification and reporting of two categories of hybrid securities (depository shares and capital trust securities (also referred to as trust preferred securities)) to clarify the appropriate trade reporting facility to which such securities should be reported.<sup>6</sup> In addition, FINRA proposes 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.

#### Depository Shares

FINRA proposes to interpret the term OTC Equity Security to include a depository share that is not listed on an equity facility of a national securities exchange. Depository shares generally are securities that represent a fractional interest in a share of preferred stock, which is considered an equity security. 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. Under this interpretation, members must request a symbol, if one has not already been assigned, for such depository shares for ORF

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<sup>6</sup> 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).

reporting in compliance with the applicable reporting requirements. Members must also 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 depositary shares traded.<sup>7</sup>

### Capital Trust Securities

FINRA proposes to interpret the term TRACE-Eligible Security to include capital trust securities and trust preferred securities. Historically, many of these securities, particularly those issued with \$1,000 par value and not listed on an equity facility of a national securities exchange, were reported to Fixed Income Pricing System (“FIPS”) prior to the implementation of TRACE.<sup>8</sup> When TRACE was proposed, FIPS securities were to be transferred to TRACE.<sup>9</sup> In addition, as part of the proposal, FINRA (then NASD) specifically identified capital trust securities in a list of instruments that NASD considered TRACE-Eligible Securities, which would be reported to TRACE and otherwise subject to the FINRA Rule 6700 Series requirements.<sup>10</sup>

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<sup>7</sup> See FINRA Rule 6622; see also Trade Reporting FAQ 101.6, available at [www.finra.org/Industry/Regulation/Guidance/p038942#101](http://www.finra.org/Industry/Regulation/Guidance/p038942#101).

<sup>8</sup> FINRA (formerly, the National Association of Securities Dealers, Inc. (“NASD”)) operated FIPS through its then subsidiary, NASDAQ. FIPS began in April 1994 and collected transaction and quotation information on domestic, registered, non-convertible high-yield corporate bonds. OTC capital trust securities and trust preferred securities were treated as FIPS securities and often included in the regularly published lists of the most actively-traded FIPS securities, referred to as the “FIPS 50.” See Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001) (Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4, Relating to the Creation of a Corporate Bond Trade Reporting and Transaction Dissemination Facility and the Elimination of Nasdaq’s Fixed Income Pricing System) (File No. SR-NASD-99-65) (“SEC TRACE Approval Order”).

<sup>9</sup> See, e.g., SEC TRACE Approval Order, 66 FR 8131, at 8132-8133, note 13 and note 16.

<sup>10</sup> In SR-NASD-99-65, FINRA (then NASD) indicated that capital trust securities would be TRACE-Eligible Securities. See Securities Exchange Act Release No. 42201 (December 3, 1999), 64 FR 69305, at 69309 (December 10, 1999) (Notice of Filing of Proposed Rule Change Relating to the Creation of a Corporate Bond Trade Reporting and Transaction

FINRA is clarifying that 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) must be reported to TRACE (and not to ORF) and transactions in such securities must be reported in compliance with the applicable reporting requirements.<sup>11</sup> For example, price should be reported as a percentage of par value and volume should be reported as the total par value of the transaction (not the number of bonds traded).<sup>12</sup>

#### Hybrid Securities Currently Being Reported to ORF and TRACE

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 effective date of this proposed rule change, securities that are affected by this 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 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 depositary shares reported to TRACE prior to the effective date of this proposed

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Dissemination Facility and the Elimination of Nasdaq's Fixed Income Pricing System ("FIPS")) (File No. SR-NASD-99-65); see also SEC TRACE Approval Order.

<sup>11</sup> 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.

<sup>12</sup> See FINRA Rule 6730.

rule change.<sup>13</sup> However, if a firm reported a transaction to the facility designated in this proposed interpretation, but did not report in accordance with 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 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 90 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,<sup>14</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable

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<sup>13</sup> 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 (November 2008).

<sup>14</sup> 15 U.S.C. 78o-3(b)(6).

principles of trade, and, in general, to protect investors and the public interest. FINRA believes that by clarifying the classification of certain hybrid securities 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 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.

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](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2013-039 on the subject line.

##### 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 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 the filing will also be available for inspection and copying at principal office of FINRA. 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.<sup>15</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>15</sup> 17 CFR 200.30-3(a)(12).