

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-78759; File No. SR-FINRA-2016-024)

September 2, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change to Create an Academic Corporate Bond TRACE Data Product

I. Introduction

On June 28, 2016, 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 amend FINRA Rule 7730 to create a new data product consisting of data on historic transactions in corporate bonds reported to the Trade Reporting and Compliance Engine (“TRACE”) that would be available to institutions of higher learning (the “Academic Corporate Bond TRACE Data product”). The proposed rule change was published for comment in the Federal Register on July 7, 2016.³ The Commission received three comments in response to the proposal.⁴ On August 9, 2016, FINRA extended to September 2, 2016, the time period within which the Commission shall approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether the proposed rule change should be

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 78219 (July 1, 2016), 81 FR 44359 (“Notice”).

⁴ See letters to Brent J. Fields, Secretary, Commission, from Sean Davy, Managing Director, Capital Markets Division and Leslie M. Norwood, Managing Director and Associate General Counsel, Municipal Securities Division, SIFMA, dated July 27, 2016 (“SIFMA Letter”); Mike Nicholas, Chief Executive Officer, BDA, dated July 28, 2016 (“BDA Letter”); and Kumar Venkataraman, Ph.D., James M. Collins Chair in Finance, Edwin L. Cox School of Business, Southern Methodist University, dated August 9, 2016 (“Venkataraman Letter”).

disapproved.⁵ FINRA responded to the comments on August 23, 2016.⁶ This order grants approval of the proposed rule change.

II. Description of the Proposed Rule Change

FINRA has proposed to make available to institutions of higher learning a new Academic Corporate Bond TRACE Data product that would contain transaction-level data on historic transactions in corporate bonds and would include masked counterparty information. Currently, FINRA makes publicly available real-time data in TRACE-eligible securities and a Historic TRACE Data product that provides transaction-level data, on an 18-month delayed basis, without any counterparty information.⁷

In the Notice, FINRA stated that academic researchers cannot use the existing Historic TRACE Data product to track the behavior of an individual dealer or group of dealers due to the lack of any counterparty information. FINRA stated that this proposal responds to requests from academics for FINRA to make available an enhanced data product that includes counterparty identification.⁸ FINRA has represented that establishing a new TRACE data product with masked counterparty identifiers could allow academic researchers to track activity in a variety of ways, including by individual dealer or by groups of dealers, and could facilitate the ability of academic researchers to study the impact of various events on measures such as intermediation

⁵ See letter to Katherine England, Assistant Director, Division of Trading and Markets, Commission, from Racquel L. Russell, Associate General Counsel, Regulatory Policy and Oversight, FINRA, dated August 9, 2016.

⁶ See letter to Brent J. Fields, Secretary, Commission, from Racquel L. Russell, Associate General Counsel, Regulatory Policy and Oversight, FINRA, dated August 23, 2016 (“FINRA Response Letter”).

⁷ See FINRA Rule 7730(f)(4). See also Securities Exchange Act Release No. 61012 (November 16, 2009), 74 FR 61189 (November 23, 2009) (Order Approving File No. SR-FINRA-2007-006).

⁸ See Notice, 81 FR at 44359.

costs, dealer participation, and liquidity.⁹

The proposal would amend FINRA Rule 7730 to create a new Academic Corporate Bond TRACE Data product consisting of historic transaction-level data on all transactions in corporate bonds reported to TRACE, including Rule 144A transactions in corporate bonds but not including transactions that are List or Fixed Offering Price Transactions¹⁰ or Takedown Transactions.¹¹ FINRA noted that the existing Historic TRACE Data product also does not include List or Fixed Offering Price Transactions or Takedown Transactions. Under the proposal, a transaction included in the Academic Corporate Bond TRACE Data product would be aged at least 36 months before being incorporated into the dataset. Each such transaction would not include any MPIDs, but would instead include a masked dealer identifier.¹²

The Academic Corporate Bond TRACE Data product would be available only to institutions of higher education.¹³ Any institution of higher education subscribing to the product

⁹ See id.

¹⁰ FINRA Rule 6710(q) defines “List or Fixed Offering Price Transaction” as a primary market sale transaction sold on the first day of trading of a security, excluding a Securitized Product as defined in FINRA Rule 6710(m) other than an Asset-Backed Security as defined in FINRA Rule 6710(cc): (i) by a sole underwriter, syndicate manager, syndicate member, or selling group member at the published or stated list or fixed offering price; or (ii) in the case of a primary market sale transaction effected pursuant to Securities Act Rule 144A, by an initial purchaser, syndicate manager, syndicate member, or selling group member at the published or stated fixed offering price.

¹¹ FINRA Rule 6710(r) defines “Takedown Transaction” as a primary market sale transaction sold on the first day of trading of a security, excluding a Securitized Product other than an Asset-Backed Security: (i) by a sole underwriter or syndicate manager to a syndicate or selling group member at a discount from the published or stated list or fixed offering price; or (ii) in the case of a primary market sale transaction effected pursuant to Securities Act Rule 144A, by an initial purchaser or syndicate manager to a syndicate or selling group member at a discount from the published or stated fixed offering price.

¹² See proposed FINRA Rule 7730(g)(5).

¹³ See proposed FINRA Rule 7730(e).

would be required to agree: (1) not to attempt to reverse-engineer the identity of any market participant; (2) not to redistribute the data; (3) to disclose each intended use of the data (including a description of each study being performed and the names of each individual who will have access to the data for the study); (4) to ensure that any data presented in work product be sufficiently aggregated to prevent reverse engineering of any dealer or transaction; and (5) to return or destroy the data if the agreement is terminated.¹⁴

FINRA stated that it would announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval, and that the effective date would be no later than 270 days following publication of that Regulatory Notice.¹⁵ In addition, FINRA stated that it plans to file a separate proposed rule change to address market data fees for the Academic Corporate Bond TRACE Data product before the effective date of this proposal.¹⁶

III. Summary of Comments and FINRA's Response

The Commission received three comments on the proposed rule change¹⁷ and a response letter from FINRA.¹⁸ Two commenters generally supported the proposal. One of these commenters, an academic researcher, stated that, “[t]o study the impact of banking regulation on bond dealers, it is necessary to obtain information on the identity of dealers associated with each transaction. The Historic TRACE data product does not contain this information.”¹⁹ The commenter pointed to the masked dealer identifier information in the new proposed product as a

¹⁴ See Notice, 81 FR at 44359-60.

¹⁵ See id. at 44360.

¹⁶ See id. at 44359, n.7.

¹⁷ See supra note 4.

¹⁸ See supra note 6.

¹⁹ Venkataraman Letter at 2.

significant advantage over the Historic TRACE Data product, and stated that he “expect[s] that FINRA’s new Academic data initiative will lead to an explosion in academic research on corporate bonds and provide new insights on the functioning of the bond market.”²⁰

A second commenter, while generally supportive of the proposal, expressed the view that FINRA could make modifications to provide additional protections against the potential for reverse engineering the data without impeding its goals of promoting academic access and research.²¹ This commenter stated that the potential impact of reverse engineering could include deciphering a dealer’s trading strategies and revealing confidential business information relating to specific client transactions.²²

A third commenter opposed the proposal, arguing that it would expose dealers and their customers to unnecessary risks.²³ The commenter stated, for example, that “[i]t is very likely that, as a consequence of this proposal, private and non-educational entities will end up possessing full trade history including dealer names for every trade released.”²⁴

The two industry commenters offered differing views on aspects of the proposal that FINRA designed to reduce the risk of reverse engineering specific dealer identities. The second commenter thought that limiting the scope of the data product to transactions in corporate bonds, including Rule 144A transactions but excluding information on List or Fixed Offering Price Transactions or Takedown Transactions, would mitigate the risk of reverse engineering.²⁵ The second commenter also acknowledged that the proposal’s aging period of 36 months (expanded

²⁰ Id. at 3.

²¹ See SIFMA Letter at 2.

²² See id. at 3.

²³ See BDA Letter at 1.

²⁴ Id. at 2.

²⁵ See SIFMA Letter at 2.

from 24 months in an earlier iteration) would help reduce the risk of reverse engineering, but thought that an aging period of no less than 48 months would be more appropriate.²⁶ The third commenter supported the exclusion of List or Fixed Offering Price Transactions from the scope of the proposal and acknowledged that expanding the aging period and masking dealer identities would make reverse engineering more difficult, but expressed the view that these measures were not sufficient to reduce the risk of reverse engineering to an acceptable level.²⁷

In addition, the two industry commenters suggested that FINRA make the transaction data available according to groupings of comparable dealers, instead of on an individual dealer level, arguing that masked dealer identifiers might not effectively protect their identities.²⁸ The academic commenter, who supported the proposal without modification, objected to this suggestion of the other commenters and argued that providing the data by pre-set groupings could stifle academic research. This commenter explained that individual dealer-level data would allow academic researchers to maintain needed flexibility to construct samples of dealers in a manner best suited to their specific research question.²⁹

The two industry commenters also offered suggestions regarding strengthening and enforcing the proposed user agreements. The second commenter urged FINRA to develop “robust operational frameworks around the execution and ongoing oversight of user agreements

²⁶ See id.

²⁷ See BDA Letter at 1-2.

²⁸ See SIFMA Letter at 3 (suggesting that FINRA aggregate dealers by the peer group criteria used in FINRA report cards); BDA Letter at 2-3 (suggesting that FINRA aggregate dealers by size).

²⁹ See Venkataraman Letter at 3. For example, the commenter noted that academic researchers may wish to aggregate dealers into groups based on whether or not they are active market makers with high market share, whether they specialize in high yield bonds or investment grade bonds, or whether they increase liquidity provision or withdraw participation when volatility is high. See id.

. . . [in order to] further mitigate concerns of reverse engineering and information leakage.”³⁰

The third commenter stated that, although the proposed user agreements are designed to prevent redistribution of the data, federal and state Freedom of Information Act (“FOIA”) laws could defeat such intention if the transaction data is held by a public university and classified as a public record.³¹ This commenter also raised concerns about data security, suggesting that the data could be subject to hacking or data theft during transmission or when held by an institution of higher education.³²

In its response to these comments, FINRA stated that it “continues to believe that the instant proposal strikes the appropriate balance between addressing risks regarding potential reverse engineering with facilitating the ability of academic researchers to study the market for corporate bonds.”³³ FINRA explained that it made significant changes to an earlier iteration of the proposal, including limiting the scope of the proposed data product to corporate bonds. In FINRA’s view, transaction data on corporate bonds does not present a high risk of accurate reverse engineering because generally these bonds are traded by a greater number of dealers.³⁴ FINRA also noted that it raised the minimum age of included transactions from 24 months to 36 months. FINRA expressed its belief that the “totality of the measures” included in this proposal adequately address the commenters’ concerns.³⁵ FINRA also stated that the user agreements will include provisions geared towards data security and designed to limit the risk of public

³⁰ SIFMA Letter at 4.

³¹ See BDA Letter at 2.

³² See id.

³³ FINRA Response Letter at 2.

³⁴ See id. FINRA also noted that any reverse engineering of market participant identities would be in direct contravention of explicit prohibitions in the user agreements. See id.

³⁵ See id.

disclosure due to federal or state FOIA requests. FINRA noted that it will utilize its existing processes to oversee user agreements. FINRA further explained that it will monitor use of the Academic Corporate Bond TRACE Data product and may consider amending or discontinuing the product if it finds that academics are reverse engineering the data.³⁶

Finally, although one commenter suggested expanding the user group for Academic Corporate Bond TRACE Data to other non-profit organizations engaged in research activities,³⁷ FINRA responded that “in light of the sensitivities” surrounding making transaction-level data available, even with masked dealer identifiers, “FINRA believes it is appropriate to restrict the availability of Academic Corporate Bond TRACE Data to institutions of higher education at this time.”³⁸

IV. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.³⁹ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,⁴⁰ which requires, among other things, that FINRA’s 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 establishing the Academic Corporate Bond TRACE Data

³⁶ See id. at 2-3 and n. 4.

³⁷ See SIFMA Letter at 4-5.

³⁸ FINRA Response Letter at 3. FINRA noted that non-academic institutions may still subscribe to Historic TRACE Data, which includes transaction-level data without dealer-level information. See id.

³⁹ In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁴⁰ 15 U.S.C. 78o-3(b)(6).

product in the manner described in the proposal is reasonable and consistent with the Act. The Commission does not believe that the commenters have raised any issue that would preclude approval of the proposal at this time. The proposal appears reasonably designed to minimize the possibility that the product might reveal the identities or trading strategies of particular market participants. FINRA has limited the scope of the data product to include only transactions in corporate bonds, will mask counterparty identities, is requiring transaction data to be aged 36 months prior to inclusion, and will require subscribers to execute a user agreement imposing restrictions on use of the data. The required user agreements appear reasonably designed to limit information leakage while providing institutions of higher education a potentially important new tool to analyze concerns about bond market liquidity.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴¹ that the proposed rule change (SR-FINRA-2016-024) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴²

Brent J. Fields
Secretary

⁴¹ 15 U.S.C. 78s(b)(2).

⁴² 17 CFR 200.30-3(a)(12).