

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83393; File No. SR-FINRA-2018-023)

June 7, 2018

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 6730 Relating to ATS Reporting of Transactions to TRACE in U.S. Treasury 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 June 5, 2018, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “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 Rule 6730 to require alternative trading systems (“ATSs”) that report transactions in U.S. Treasury Securities to the Transaction Reporting and Compliance Engine (“TRACE”) to identify non-FINRA member subscribers on those transaction reports.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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 the Statutory Basis for, the Proposed Rule Change

1. Purpose

On October 18, 2016, the SEC approved a proposed rule change to require FINRA members to report secondary market transactions in U.S. Treasury Securities to TRACE,³ and on July 10, 2017, FINRA members began reporting transaction information on U.S. Treasury Security transactions through TRACE.⁴ As approved, TRACE transaction information in U.S. Treasury Securities is for regulatory purposes only and is not disseminated publicly.⁵

As with all TRACE reporting, transactions in U.S. Treasury Securities that occur on an ATS generally must be reported to TRACE by the counterparties, if they are FINRA members, and by the ATS itself.⁶ A significant amount of trading activity in U.S. Treasury Securities on ATSs involves market participants that are not registered as broker-dealers or are not FINRA members, including, for example, hedge funds, banks and principal trading firms (“PTFs”). As the U.S. Department of the Treasury (“Treasury Department”) noted in its recent Capital Markets Report, “[t]rading activity [in U.S. Treasury Securities] on the major electronic interdealer

³ See Securities Exchange Act Release No. 79116 (October 18, 2016), 81 FR 73167 (October 24, 2016) (Order Granting Accelerated Approval of File No. SR-FINRA-2016-027).

⁴ See Regulatory Notice 16-39 (October 2016).

⁵ See Rule 6750(c)(5).

⁶ See Regulatory Notice 14-53 (November 2014). There are limited exemptions available where all the counterparties are FINRA members, which would not apply where a transaction on an ATS involves a non-FINRA member.

platforms is dominated by PTFs, . . . and collectively they account for over half of all transaction volumes in the interdealer broker segment of the [cash Treasury] market.”⁷ Although the Capital Markets Report does not define a “PTF,” the Joint Staff Report identifies the following as typical characteristics of PTFs: (i) principal investor; (ii) deploys proprietary automated trading strategies; (iii) low latency is typically a key element of the trading strategies; and (iv) may be registered as a broker-dealer but does not have clients as in a typical broker-dealer business model.⁸

Because each current ATS is a FINRA member, all of the trading activity in TRACE-Eligible Securities occurring on an ATS is required to be reported to TRACE by that ATS; however, the identities of non-FINRA members (including, but not limited to, hedge funds, banks and PTFs) trading on the ATSs are not reported because they are treated as customers, not FINRA members. Thus, while an ATS identifies a specific FINRA-member counterparty on its TRACE reports by that counterparty’s market participant identifier (“MPID”), for transactions involving non-FINRA members, the ATS reports the trade as a generic customer trade and identifies the counterparty only with a “C” identifier. Because of this, as the Capital Markets

⁷ See Treasury Department, A Financial System That Creates Economic Opportunities: Capital Markets, Report to President Donald J. Trump, Executive Order 13772 on Core Principles for Regulating the United States Financial System, at 79-80 (October 2017) (“Capital Markets Report”), <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>. The Capital Markets Report cited the July 13, 2015 Joint Staff Report (“Joint Staff Report” or “JSR”) issued by the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the SEC, and the U.S. Commodity Futures Trading Commission (Inter-Agency Working Group for Treasury Market Surveillance members (IAWG) or “official sector”) in response to unusually high levels of volatility and a very rapid round-trip in prices that occurred in the market for U.S. Treasury Securities, futures, and other related financial products on October 15, 2014, https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf.

⁸ See JSR, at 50.

Report noted, “[i]n essence, a significant portion of PTF activity is anonymized in the TRACE data.”⁹ The Treasury Department therefore recommended “closing the gap in the granularity of PTF data” by requiring ATSs that facilitate transactions in U.S. Treasury Securities “to identify customers in their reports of Treasury security transactions to TRACE.”¹⁰

To assess the scope of non-FINRA member trading activity in U.S. Treasury Securities on ATSs, FINRA analyzed transaction data submitted to TRACE and found that, consistent with the views expressed in the Capital Markets Report, the majority of trades in U.S. Treasury Securities reported by ATSs do not identify the subscriber that is a counterparty to the trade. Because a significant portion of ATS trades in U.S. Treasury Securities involves unidentified counterparties, the trading data available to FINRA and the official sector is incomplete. Requiring specific subscriber information in ATS TRACE reports for transactions in U.S. Treasury Securities would enhance the information available to FINRA and the official sector and facilitate a better understanding U.S. Treasury market structure and liquidity. As the Treasury Department noted in the JSR, “an event like October 15 highlights the need to better understand various factors that are impacting liquidity in the U.S. Treasury market, especially during stressed market conditions . . . [including] . . . changes in intermediation, automated trading, regulation, and buy and sell-side participation that may have altered trading practices as well as the sources and characteristics of liquidity provision.”¹¹

⁹ See Capital Markets Report, at 80.

¹⁰ Id. The Capital Markets Report recommends “closing the gap in the granularity of PTF data,” and also recommends requiring ATSs to identify “customers” in their TRACE reports, which is a broader term than “PTFs.” FINRA staff intends to work with the staff of the Treasury Department to ensure the scope of the reporting requirement is appropriate and meets regulatory needs in light of the recommendations in the Capital Markets Report.

¹¹ See JSR, at 45.

In addition, FINRA believes that the proposed rule change would result in an improvement to the effectiveness of FINRA’s surveillance patterns from the standpoint of greater granularity and thus more accurate pattern detection, including the increased ability to identify potentially manipulative activity. For example, FINRA’s ability to detect wash sales or prearranged trading activity would be improved if the audit trail included the identity of the non-FINRA member counterparty rather than the generic customer indicator received today. The identity of the particular ATS subscriber allows the surveillance pattern to narrow down the potential universe of matching trades and thus more accurately detect instances of potential manipulation. As such, the additional detail that would be added to transaction reports by identifying non-FINRA member counterparties would enhance FINRA’s surveillance program for U.S. Treasury Securities.

Consequently, as recommended in the Capital Markets Report, FINRA is proposing to require member ATSS with a minimum threshold of trading (“covered ATS”) to identify non-FINRA member subscribers associated with their TRACE trade reports in U.S. Treasury Securities. Specifically, FINRA proposes that a “covered ATS” would mean an ATS, as that term is defined in Rule 300 of SEC Regulation ATS,¹² that executed transactions in U.S. Treasury Securities with non-FINRA member subscribers of \$10 billion or more in monthly par value, computed by aggregating buy and sell transactions, for any two months in the preceding

¹² See 17 CFR 242.300(a). As is the case with FINRA Rule 6720(c) (Alternative Trading Systems), any member that meets the definition of “alternative trading system” set forth in Rule 300 of Regulation ATS would be required to comply with the proposed rule change irrespective of whether such member is excepted from the requirements applicable to ATSS provided in Rule 301(b) of Regulation ATS (e.g., such as where the member limits its securities activities to government securities). See 17 CFR 242.301(a)(4)(ii)(A).

calendar quarter.¹³ Pursuant to proposed Supplementary Material .07, each covered ATS would be required to provide FINRA a list of its non-FINRA member subscribers, as defined in Rule 300 of SEC Regulation ATS, which would include entities such as PTFs, hedge funds and banks. Based on the lists provided by the ATSS, FINRA would then assign each non-FINRA member subscriber a unique MPID and provide that MPID to each covered ATS to which the non-FINRA member subscribes so that each non-FINRA member subscriber can be identified consistently across all ATSS.¹⁴ Under this approach, the confidentiality of an individual ATS's subscriber list would be preserved because FINRA would provide each ATS a list of MPIDs based solely on the customer list provided to FINRA by that ATS. Each covered ATS would then use the assigned MPID in the contra-party field for purposes of identifying each non-FINRA member counterparty, as required by Rule 6730(c)(6), in place of using the current designations for contra-party "customer" or "non-member affiliate" identifiers.

If an ATS becomes a covered ATS subsequent to the compliance date of the proposed rule, it must comply with new Supplementary Material .07 within 60 calendar days of the end of the calendar quarter in which it becomes a covered ATS. FINRA believes that 60 calendar days would afford sufficient time for a newly covered ATS to provide FINRA a list of, and obtain MPIDs for, its non-FINRA member subscribers, and to perform any programming changes necessary to accurately reflect in TRACE reports non-FINRA member counterparties using the MPIDs assigned by FINRA.

¹³ Based on a sample review period of Treasury transaction data reported to FINRA, the top six ATSS by volume would be considered "covered ATSS" and account for over 99% of the trade reports submitted by ATSS to TRACE for U.S. Treasury Securities.

¹⁴ Some non-members may have multiple MPIDs assigned to them, for example if they use separate aggregation units or desks to access or trade through the ATS, in which case the unit assigned the MPID is the subscriber for purposes of this rule proposal.

Once an ATS becomes a “covered ATS” under the rule, it will remain within the scope of the definition. Thus, a covered ATS must continue to identify each non-FINRA member subscriber in the contra-party field using the MPID assigned by FINRA, irrespective of whether its volume of executed transactions in U.S. Treasury Securities with non-FINRA member subscribers falls below \$10 billion in par value in the future. In removing the current differentiation between subscribers that are FINRA members and those that are not, and requiring the use of an MPID by the ATS when reporting transactions in U.S. Treasury Securities regardless of the subscriber’s status as a FINRA member, FINRA believes that the proposal would improve the completeness of the information on transactions in U.S. Treasury Securities available to FINRA and the official sector.

Because a significant number of ATSs have minimal volume of executions with non-FINRA members in U.S. Treasury Securities, the proposed rule change would not apply to ATSs whose par value traded in U.S. Treasury Securities with non-FINRA member subscribers is below \$10 billion per month for any two months in the preceding calendar quarter. FINRA believes that this approach is appropriate in that it limits the application of the proposed requirement to the member ATSs that are most active in trading U.S. Treasury Securities with non-FINRA members, and, as such, responsible for submitting most of the ATS trade reports for transactions in U.S. Treasury Securities against non-FINRA members. Limiting the proposed counterparty identification requirement in this manner balances the burdens associated with complying with the proposed rule (i.e., providing FINRA a list of all non-FINRA member subscribers, obtaining an MPID from FINRA, and using the assigned MPID in TRACE reporting), with the benefits sought to be achieved by the proposed requirement (i.e., additional

granularity that will enhance the quality of the information available to FINRA and the official sector on transactions in U.S. Treasury Securities).

FINRA does not believe that the absence of more detailed counterparty information from those ATSS with activity levels below the proposed threshold will materially affect the completeness of the audit trail. However, if approved, FINRA intends to monitor the continued appropriateness of the \$10 billion dollar threshold to ensure that this amount remains relevant in light of market changes. In addition, FINRA intends to monitor the impact of this exception on its audit trail, as well as for any potential negative impacts or changes in ATS or non-member subscriber behavior.

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 180 days following publication of the Regulatory Notice announcing Commission approval. ATSS would be required to submit a list of its non-member subscribers to FINRA at least 60 days in advance of the effective date.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁵ 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 and Section 15A(b)(9) of the Act,¹⁶ which requires that FINRA rules not impose any burden on competition that is not necessary or appropriate. FINRA believes that the proposed rule change will make

¹⁵ 15 U.S.C. 78o-3(b)(6).

¹⁶ 15 U.S.C. 78o-3(b)(9).

TRACE reporting of U.S. Treasury Securities transactions more complete and thus enable FINRA to better identify potentially abusive trading activity in the Treasury market that is already reported to TRACE but is anonymized because of the existing limitations on customer identification. Because this activity by non-FINRA members constitutes a significant portion of ATS trading activity in U.S. Treasury Securities, the proposed rule change will significantly enhance FINRA's surveillance efforts as well as the trading data available to the official sector. As the Commission has noted in the past, improved surveillance capabilities can help FINRA detect and deter fraudulent and manipulative acts and practices, and thus promote just and equitable principles of trade and the protection of investors and the public interest. In addition, this collection is the "type of additional data reporting to the official sector necessary to continue to effectively monitor the functioning of the Treasury market and meet the IAWG mission."¹⁷

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 Impacts

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the need for the proposed rulemaking, the regulatory objective of the proposal, the economic baseline of analysis, the anticipated economic impacts, and the alternatives considered.

(a) Purpose and Regulatory Objective

The proposed change to Rule 6730 would require ATSs that meet a minimum threshold of trading against non-FINRA member subscribers to identify such subscribers on TRACE transaction reports for U.S. Treasury Securities. FINRA proposes to require ATSs to identify

¹⁷ See JSR, at 49.

such non-FINRA members on TRACE transaction reports to enhance the quality of the information available to FINRA and the official sector on transactions in U.S. Treasury Securities.

(b) Economic Baseline

As discussed above, FINRA members have been reporting transaction information on U.S. Treasury Securities to TRACE since July 10, 2017 and such information is used solely for FINRA and official sector use. Since then, a majority of the trades in this market can be attributed to non-FINRA members.

Current TRACE reporting requirements enable FINRA to identify the ATS on which a transaction occurs as well as the other members that are parties to those transactions. However, FINRA does not have similar insight into the identity of the non-FINRA members that are parties to transactions on ATSS because such participants are identified as either a customer or a non-member affiliate.

The proposed rule change would apply to ATSS that report transactions in U.S. Treasury Securities to TRACE. As mentioned in FINRA's filing that required the reporting of U.S. Treasury Securities transactions to TRACE, "[t]he Treasury cash market has been bifurcated between the inter-dealer market, in which dealers trade with one another, and the dealer-to-customer market, where customers may include asset managers, pension funds, insurance companies, and corporations."¹⁸ A number of entities that are not registered broker-dealers are currently part of the inter-dealer market but they are not identified in TRACE reports.

¹⁸ See Securities Exchange Act Release No. 78359 (July 19, 2016), 81 FR 48465 (July 25, 2016) (Notice of Filing of File No. SR-FINRA-2016-027).

(c) Economic Impacts

FINRA believes that the proposed rule change to require ATSS to identify non-FINRA members in TRACE reports for U.S. Treasury Securities transactions should potentially impact a small number of ATSS (i.e., those whose activity is at or above the minimum threshold discussed above).

Between July 10, 2017 and March 31, 2018, there were 17 ATSS on which U.S. Treasury Securities were traded. A significant amount of the trading volume, involved at least one market participant not registered as a broker-dealer. Six of these ATSS had transaction volume of \$10 billion or more in par value in at least two months in a given calendar quarter against non-FINRA members and would have been subject to the requirement had the proposed rule been in place.¹⁹ The total trading volume of the six ATSS against non-FINRA member subscribers accounted for more than 99.9% of trading by non-FINRA member subscribers across all ATSS.

FINRA reached out to several ATSS to inquire about the potential sources of costs. ATSS that are most active in trading of U.S. Treasury Securities with non-FINRA members, and hence may have volumes at or above the proposed volume threshold, may potentially need to update the existing systems or build new systems and develop protocols in order to provide FINRA with a list of all non-FINRA member subscribers, obtain a corresponding list of MPIDs from FINRA, and use the assigned MPIDs in TRACE reporting. FINRA understands that the proposed requirement would also entail quality assurance testing relating to identifying clients and matching the assigned MPIDs with the client list.

¹⁹ The six ATSS had transaction volume of more than \$10 billion in par value in all of the months in our sample period, while the remaining 11 ATSS never reached the threshold in any of the months.

FINRA also considered the potential impacts of the proposed identification requirement on non-FINRA member subscribers. To the extent that such participants prefer avoiding identification in TRACE reporting, they may shift some or all of their trading activity to other ATSS that are below the threshold. Non-FINRA member subscribers may also incur search costs or may have to pay a liquidity premium in case there is lighter trading on such ATSS.

Alternatively, trading may shift to FINRA-registered broker-dealers that are not ATSS or to venues that are not under FINRA jurisdiction, such as banks, and thus have no reporting obligations to TRACE. However, based on conversations with the industry, FINRA understands that most trading in this market is electronic and member firms and non-FINRA venues do not currently have the capability to facilitate the volume of orders and trades that FINRA-member ATSS can facilitate through electronic systems. FINRA cannot predict if non-FINRA member market participants will ultimately find it more beneficial to establish an alternative venue that is not required to report to TRACE, but will monitor for such a potential outcome.

(d) Alternatives Considered

FINRA considered various approaches to identifying non-FINRA members that are parties to reported transactions in U.S. Treasury Securities and engaged in discussions with ATSS and other stakeholders. One alternative considered was to require each ATS to provide a monthly list of all of its non-FINRA member subscribers and identify each of its customers on TRACE reports for U.S. Treasury Securities. This approach, which would cover the broadest range of subscribers, would identify all of an ATS's subscribers regardless of the ATS's amount of trading activity. Another alternative considered was to require each ATS to provide FINRA with its order book information, including providing each customer's order book activity rather than identifying individual customers on TRACE trade reports. FINRA would then link the

order book information to the trade reports. Like the first option, this alternative would provide FINRA with complete insight into each customer's activity on the ATS; however, FINRA would be compiling the transaction data from the order book information submitted by ATSs, rather than having the ATSs identify customers when reporting to TRACE.

However, the analysis of the transaction data and careful consideration of the trade-offs between the costs associated with collecting transaction or order book information from each ATS and the incremental value the information brings to the surveillance program, concluded that the proposed approach would cover a significant amount of non-FINRA member customer activity, and enhance the quality of the information available to FINRA and the official sector on transactions in U.S. Treasury Securities.

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-2018-023 on the subject line.

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-2018-023. 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-2018-023, 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.²⁰

Eduardo A. Aleman
Assistant Secretary

²⁰ 17 CFR 200.30-3(a)(12).