SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71180; File No. SR–FINRA–2013–039]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc; Order Instituting Proceedings To Determine Whether To Disapprove Proposed Rule Change To Clarify the Classification and Reporting of Certain Securities to FINRA

December 24, 2013.

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. This order institutes proceedings under Section 19(b)(2)(B) of the Act [5] to determine whether to disapprove the proposed rule change.

II. Description of the Proposal

FINRA employs trade reporting rules that generally require that members report over-the-counter (''OTC'') transactions in eligible debt and equity securities to FINRA.[6] FINRA Rule 6622 requires that members report transactions in ''OTC Equity Securities'' to ORF [7] and the Rule 6700 Series requires members to report transactions in ''TRACE-Eligible Securities'' to TRACE.[8]

The current proposal would clarify how members would be required to report two classes of securities—''depositary 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.[9] FINRA states that it has 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 has proposed to classify depositary shares, when not listed on an equity facility of a national securities exchange,[10] as OTC Equity Securities under FINRA Rule 6420(f).[11] As such, depositary shares would be equity securities reportable to ORF. According to FINRA, depositary shares generally are securities that represent a fractional interest in a share of preferred stock, and preferred stocks are considered equity securities. FINRA notes further that depositary shares generally entitle the holder, through the depositary, to a proportional fractional interest in the rights, powers, and preferences of the preferred stock represented by the depositary share.[12]

Under the proposal, FINRA members would be required to request a symbol for a depository share, if one had not already been assigned, and to report transactions in depositary shares in accordance with ORF requirements. Thus, the price of the transaction would be reported as the dollar price per share and volume should be reported as the number of depositary shares traded.[13]

With respect to capital trust (or trust preferred) securities, FINRA has proposed to include such securities within the definition of ''TRACE-Eligible Security'' under FINRA Rule 6710(a).[14] 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).[15]

In explaining its proposed classification of capital trust securities, FINRA noted that, 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.[16] When TRACE was proposed, reporting of FIPS securities was to be transferred to TRACE.[17] FINRA also noted that, as part of the original TRACE 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

[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] 15 U.S.C. 78s(b)(2)(B).

[6] *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'')).

[7] 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).''

[8] 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.''

[9] *See* Notice, 78 FR at 59996.

[10] FINRA's proposed interpretation would apply 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 (applying 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 FINRA's 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.

[11] *See supra* note 7.

[12] *See* Notice, 78 FR at 59996.

[13] *See* FINRA Rule 6622; *see also* Trade Reporting FAQ 101.6, available at *www.finra.org/Industry/Regulation/Guidance/p038942#101.*

[14] *See supra* note 8.

[15] *See* FINRA Rule 6730.

[16] FINRA (formerly, the National Association of Securities Dealers, Inc. (''NASD'')) operated FIPS through its then-subsidiary, NASDAQ. FIPS commenced operation 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) (''TRACE Approval Order'').

[17] *See, e.g.,* TRACE Approval Order, 66 FR at 8132–8133, nn. 13 and 16.

TRACE and otherwise subject to the Rule 6700 Series requirements.[18]

FINRA stated that the proposed rule change 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 were reported contrary to the terms of the proposal. If the proposal became effective, however, it would require FINRA members to cancel and re-report trades that occurred after the date of the proposal's effectiveness if those trades were reported incorrectly.[19]

III. Comment Letters

As noted above, the Commission received two comment letters concerning the proposal.[20] Both comment letters express concern with FINRA's proposed guidance regarding trade reporting of hybrid preferred securities, such as depositary shares, and contend that hybrid securities currently being reported to TRACE should continue to be reported to TRACE. FINRA has not yet submitted a response to the comments.

The commenters make several arguments as to why depositary shares should continue to be reported to TRACE, rather than to ORF, as the proposal would require. According to the commenters, it is longstanding market practice to treat depositary shares more like debt than equity securities. The commenters also claim that it would be overly burdensome for market participants to make the technological changes required to report trades in depositary shares to ORF rather than TRACE.

One of the commenters states 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 yield and credit quality rather than on the potential for capital appreciation.[21] As a result, the commenter states, investors in hybrid securities, often institutional investors, make portfolio allocations based on yield, time to first call, and credit rating among other debt-like characteristics.[22] The commenter acknowledges, however, that hybrid securities, including depositary shares, may also be issued with par values less than $1,000, and that such smaller par value securities most often trade as equity securities in an equity format.[23]

This commenter takes the position that there is justification to support the current market practice of treating depositary shares with $1,000 par value or greater as debt securities. For instance, the commenter notes that hybrid securities, including depositary shares, generally hold a similar priority in the capital structure, meaning they are paid after all other debt and prior to common equity.[24] Additionally, according to the commenter, hybrid securities tend to share core characteristics such as a fixed coupon or dividend and a lack of voting rights beyond statutory requirements, similar to the voting rights associated with debt indentures. Hybrid securities also may or may not be callable, and they may have a specific maturity date.[25] Finally, the commenter cites a number of cases where it believes the Commission has suggested that preferred securities may properly be classified as debt securities.[26]

Furthermore, this commenter also identifies what it believes may be a significant harmful consequence of changing market practice with respect to the classification of depositary shares. The commenter notes that hybrid preferred securities, including depositary shares, are often issued by banks because of how the securities are treated for purposes of calculating a bank's regulatory capital. The commenter states that such securities are likely to become more important to banks as new, stricter standards concerning banks' capital ratios take effect. Absent a robust secondary market, the commenter contends, banks may be limited in their ability to issue hybrid preferred securities, which could impact their ability to comply with regulatory capital requirements. The commenter believes that, to the extent the proposal would change the way depositary shares are traded, it could dampen the secondary market by creating investor confusion or rendering the securities ineligible for inclusion in fixed income indices.[27]

Both commenters question the ability of market participants to adapt their systems to comply with the proposed reclassification of depositary shares. As one commenter notes, the data fields captured by FINRA's ORF are different than those captured by TRACE. 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.[28] Along the same lines, the second commenter notes that investors may prefer to receive confirmations of their depositary share trades with the additional data fields that TRACE collects but ORF does not.[29] Furthermore, the second commenter points out, many firms have bifurcated trading, operations, and technology architecture for equities and debt that is tailored to the order lifecycle needs of each type of instrument, including order entry, market data, trade reporting, and settlement.[30] In this commenter's view, the costs of altering such architecture are not warranted.[31] The first commenter expressed similar sentiment, and it also urged FINRA to allow sufficient implementation time should it proceed with the proposal.[32]

Aside from arguing for a particular treatment for depositary shares, the first commenter expressed its belief that the proposal does not contain sufficient guidance to clearly apply to the range of hybrid securities traded throughout the marketplace. This commenter offered several alternative formulations of the guidance that it believes would more thoroughly define the criteria by which a security would be classified as reportable to ORF or TRACE.[33]

IV. Proceedings to Determine Whether to Disapprove SR–FINRA–2013–039 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act[34] to determine whether the proposals should be disapproved. Institution of such

[18] 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, 69309 (December 10, 1999) (Notice of Filing of Proposed Rule Change Relating to the Creation of a Corporate Bond Trade Reporting and Transaction Dissemination Facility and the Elimination of Nasdaq's Fixed Income Pricing System (''FIPS'')).

[19] *See* Notice, 78 FR at 59996–97.

[20] *See supra* note 4.

[21] *See* SIFMA Letter at 6. *See also* FIF Letter at 1 (stating generally that the depositary shares ''are traded as fixed income securities'').

[22] *See* SIFMA Letter at 6.

[23] *See id.* at 7, n. 14.

[24] *See id.* at 6.

[25] *See id.*

[26] *See id.* at 8–9.

[27] *See id.* at 5.

[28] *See id.* at 7.

[29] *See* FIF Letter at 4.

[30] *See id.* at 1.

[31] *See id.* at 3–4. This commenter also lists a number of other potential downstream impacts that it believes FINRA should consider at greater length before proceeding with the proposal. *See id.* at 2–3.

[32] *See* SIFMA Letter at 12–14.

[33] *See id.* at 11–12.

[34] 15 U.S.C. 78s(b)(2)(B).

proceedings is appropriate at this time in view of the legal and policy issues raised by the proposals. Institution of disapproval proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to provide additional comment on the proposals.

Pursuant to Section 19(b)(2)(B),[35] the Commission is providing notice of the grounds for disapproval under consideration. The Commission notes that Section 15A(b)(9) of the Act[36] requires that FINRA's rules be designed to, among other things, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Commenters have raised concerns about whether the proposed reclassification of depositary shares for trade reporting purposes could cause harm to the market for hybrid preferred securities. They have also questioned whether the proposal could cause investor confusion, and whether it is sufficiently detailed to provide adequate guidance to market participants.

The Commission believes that these concerns raise questions as to whether the proposed rule change is consistent with the requirements of the Section 15A(b)(9) of the Act, including whether they would promote just and equitable principles of trade, perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest. As of the date of this order, FINRA had not yet addressed the comments by, for example, amending the proposal to respond to comments or arguing that the proposal should be approved by the Commission in its present form notwithstanding the comments. The self-regulatory organization submitting the proposal bears the burden of demonstrating that it is consistent with the Act, and given the outstanding comments, FINRA has not at this time satisfied that burden.[37] Accordingly, the Commission believes that it is appropriate at this time to issue this order to institute proceedings under Section 19(b)(2)(B) of the Act to determine whether to disapprove the proposed rule change.

[35] *See id.*

[36] 15 U.S.C. 78o–3(b)(6).

[37] *See* 17 CFR 201.700(b)(3).

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the concerns identified above, as well as any others they may have with the proposed rule change. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is inconsistent with Section 15A(b)(9) or any other provision of the Act, or the rules and regulation thereunder. Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b–4, any request for an opportunity to make an oral presentation.[38]

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule changes should be [approved or] disapproved by January 21, 2014. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by February 4, 2014.

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 email to *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 email 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 Web site (*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 Web site 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. 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 January 21, 2014. Rebuttal comments should be submitted by February 4, 2014.

[38] Section 19(b)(2) of the Act, as amended by the Securities Act Amendments of 1975, Public Law 94–29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. *See* Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[39]

Elizabeth M. Murphy,

Secretary.

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[39] 17 CFR 200.30–3(a)(57).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71181; File No. SR–Topaz–2013–19]

Self-Regulatory Organizations; Topaz Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to More Specifically Address the Number and Size of Contra-parties to a Qualified Contingent Cross Order

December 24, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on December 18, 2013, Topaz Exchange, LLC (d/b/a ISE Gemini) (the ''Exchange'') 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 the self-regulatory organization. The Commission is publishing this notice to

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.