

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56439; File No. SR-FINRA-2007-007)

September 13, 2007

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Exemption from Reporting for TRACE-Eligible Securities Transactions Resulting from Exercise or Settlement of Options, Termination or Settlement of Credit Default Swaps, Other Types of Swaps, or Similar Instruments

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 August 10, 2007, the Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) 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 substantially 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: (1) NASD Rule 6230(e) to exempt from reporting to the Trade Reporting and Compliance Engine (“TRACE”) transactions in TRACE-eligible securities resulting from the exercise or settlement of an option or a similar instrument, or the termination or settlement of a credit default swap (“CDS”), other type of swap, or a similar instrument (collectively, “Derivative-Related Transactions”); and (2) NASD Rule 6210(c) to conform the definition of “reportable TRACE transaction” to exclude this class and any other class of exempted transactions from the defined term. The text of the proposed rule change is available

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

on FINRA's Web site (www.finra.org), at 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 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 Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA proposes to amend NASD Rule 6230(e) to exempt transactions in TRACE-eligible securities³ that are Derivative-Related Transactions from the TRACE reporting requirements in NASD Rule 6230, and to make conforming amendments to NASD Rule 6210(c). (The TRACE reporting requirement does not exist in connection with any cash-settled derivative, even if the derivative, such as a CDS, refers to one or several securities that are TRACE-eligible securities.) Concurrently, FINRA withdraws SR-NASD-2006-103.⁴ In

³ See NASD Rule 6210 for definition of "TRACE-eligible security."

⁴ SR-NASD-2006-103 was filed with the Commission on August 28, 2006. FINRA proposed NASD IM-6230 to provide exemptive relief from certain reporting requirements for transactions executed in connection with the termination or settlement of a CDS or a similar instrument ("CDS-Related Transactions") and an amendment to NASD Rule 6250 to exempt all Derivative-Related Transactions from dissemination. See Securities Exchange Act Release No. 54681 (November 1, 2006), 71 FR 65555 (November 8, 2006) (notice of filing of proposed rule change). Among other things, in SR-NASD-2006-103, FINRA stated that the reporting requirement addressed previously in NASD Notice to Members 05-77 (November 2005) applies only to those derivative instruments that are terminated or settled in whole or in part by the purchase or sale of

addition, if the proposed rule change is approved, FINRA will rescind NASD Notice to Members 05-77 (November 2005), in which FINRA clarified members' obligations to report Derivative-Related Transactions to TRACE.⁵

FINRA believes that Derivative-Related Transactions, although technically transactions if they result in a change of beneficial ownership of TRACE-eligible securities, should not be reported for several reasons.⁶ Such transactions should be exempt from reporting because the information regarding price (and yield) being reported does not reflect a currently negotiated transaction price. The price of a transaction in a TRACE-eligible security executed in such circumstances is agreed upon at the time of the execution of a CDS or other derivative. In the event of a CDS, for example, the price is usually set at par. At the time of an event triggering a termination and settlement of a CDS such as a filing of bankruptcy, an issuer's bonds are very likely trading below par. Accordingly, the resulting Derivative-Related Transaction, if the CDS is physically settled, will be at a price that does not reflect current market conditions. FINRA recognized this in NASD Notice to Members 05-77, requiring that such transactions be reported using the "special price" flag or modifier, which is appropriately used when a transaction is executed at a price based on arm's length negotiation and done for investment, commercial, or trading considerations, but does not appear to reflect current market pricing. In addition, the pricing and time of the reporting and dissemination of certain Derivative-Related Transactions, such as CDS-related transactions, not only will not aid in price discovery, but also may create

TRACE-eligible securities ("physical settlement"), and has no application to derivatives that are cash-settled.

⁵ See NASD Notice to Members 05-77 (November 2005).

⁶ Transactions that are not reported also are not disseminated.

significant investor confusion. For example, due to the basic structure of a CDS, all or many of such Derivative-Related Transactions in a single issuer likely would occur, and be reported and disseminated during the same period. Thus, a very large number of non-market-priced transactions in the debt securities of the issuer likely would be reported and disseminated and create confusion in the marketplace, especially to retail investors who may expect pricing at par, and, in most cases, will receive quotes substantially below par. Accordingly, as prices from Derivative-Related Transactions do not contribute to price discovery, the costs of continuing to require such reporting, including potential investor confusion, argue in favor of the proposed exemption from TRACE reporting and dissemination.

Finally, the rationale underlying the proposed exemption from TRACE reporting and dissemination – price discovery does not occur and investor confusion is likely to occur – has been recognized previously by the Commission and FINRA as logical bases for exempting certain transactions from trade reporting and dissemination. For example, for many years FINRA had a similar trade reporting exemption for certain transactions in equity securities, such as transactions occurring as a result of the exercise of an over-the-counter (“OTC”) option on an equity security.⁷ Transactions from Derivative-Related Transactions should be exempt for the

⁷ Historically, purchases and sales of equity securities that occurred as a result of the exercise of an OTC option were not required to be reported to FINRA. In 2006, FINRA amended its rules to establish “Reporting . . . for Purposes of Regulatory Transaction Fee Assessment” for such equity transactions (and certain other equity transactions). The rules were changed specifically to improve FINRA’s program regarding certain fees (“Section 31 fees”) payable to the Commission to improve FINRA’s collection of transaction-based fees; the changes were not made to further either the policy to improve market surveillance or to facilitate price discovery, which are primary policy objectives of trade reporting and dissemination. Due to the nature of such reports, they are not disseminated and a member does not pay the usual fees -- certain system usage fees -- charged for trade reporting. (Under Section 31 of the Act, FINRA is required to pay transaction fees and certain other assessments to the Commission that are designed to recover the costs related to the government’s supervision and regulation of the securities

same reasons that the Commission approved such trade reporting exemptions for transactions that occurred as a result of the exercise of the derivative OTC option.

FINRA also proposes to make conforming amendments to NASD Rule 6210(c), the term “reportable TRACE transaction.” The definition currently restates a trade reporting exemption in NASD Rule 6230(e) and states that these exempt transactions are not reportable TRACE transactions. FINRA proposes to substitute a general statement regarding exempted transactions for the specific reference, which would make “TRACE reportable transaction” consistent with proposed NASD Rule 6230(e) and eliminate the need to amend NASD Rule 6210(c) each time NASD Rule 6230(e) is amended. The amendment would restate “Reportable TRACE transaction” as “any secondary market transaction in a TRACE-eligible security except transactions exempt from reporting as specified in NASD Rule 6230(e).”

FINRA would announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval, if the Commission approves the proposal. The effective date would be no later than 30 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,⁸ 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. FINRA believes that

markets and securities professionals.) See Section 31 of the Act, 15 U.S.C. 78ee and Rule 31 thereunder, 17 CFR 240.31; Securities Exchange Act Release No. 53977 (June 12, 2006), 71 FR 34976 (June 16, 2006) (order approving SR-NASD-2006-055, equity trade reporting amendments); NASD Notice to Members 06-39 (August 2006).

⁸ 15 U.S.C. 78q-3(b)(6).

Derivative-Related Transactions should be exempt from TRACE reporting because such information does not contribute to price discovery and the reporting and dissemination of such information may confuse market participants, particularly retail and non-professional investors, and investors and the public interest will be protected if the trade report information is not so reported and disseminated.

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.

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.⁹

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 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:

⁹ FINRA notes that one written comment letter was received by the Commission in response to SR-NASD-2006-103, the proposed rule change to provide exemptive relief from certain TRACE reporting requirements in NASD Rule 6230 for CDS-related transactions and to not disseminate transaction information under NASD Rule 6250 for Derivatives-Related Transactions. The commenter requested that FINRA consider providing exemptive relief beyond that proposed in SR-NASD-2006-103, and supported the proposed amendment to Rule 6250 to not disseminate Derivative-Related Transactions, except if a member would incur additional costs by being required to designate in the report that certain transactions should not be disseminated. The commenter also stated its opposition generally to any reporting and dissemination of Derivative-Related Transactions. See letter to Nancy M. Morris, Secretary, Commission, from Mary Kuan, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association, dated December 8, 2006.

- (A) by order approve 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-2007-007 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2007-007. 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 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 inspection and copying in the Commission's Public Reference Room, on official

business days between the hours of 10:00 am and 3:00 pm. 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; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2007-007 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Florence E. Harmon
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).