Regulatory Notice 18-05

Government Securities Initiative

FINRA Requests Comment on the Application of Certain Rules to Government Securities and to Other Debt Securities More Broadly

Comment Period Expires: April 9, 2018

Summary

FINRA is requesting comment on the application of the following rules to government securities, including U.S. Treasury securities: FINRA Rules 2242 (Debt Research Analysts and Debt Research Reports);[1] 5240 (Anti-Intimidation/Coordination); 5250 (Payments for Market Making); 5270 (Front Running of Block Transactions); 5280 (Trading Ahead of Research Reports); 5320 (Prohibition Against Trading Ahead of Customer Orders); and NASD Rules 1032(f) (Securities Trader), 1032(i) (Limited Representative – Investment Banking) and 1050 (Registration of Research Analysts).[2] In addition, FINRA is requesting comment on the application of FINRA Rule 5320 as well as NASD Rules 1032(f) and 1050 to all debt securities, in addition to government securities.

Questions regarding this *Notice* should be directed to:

- Afshin Atabaki, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8902; or
- Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

February 6, 2018

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Fixed Income
- Investment Banking
- Legal
- Market Making
- Operations
- Research
- Senior Management
- Trading

Key Topics

- Anti-Intimidation and Coordination
- Customer Order Protection
- Exempted Securities
- Fixed Income Securities
- Front Running
- Government Securities
- Investment Banking
- Market Making
- Research Activities
- Securities Trading
- Trading Ahead
- Treasury Securities

Referenced Rules & Notices

- Exchange Act Sections 3(a)(10), (12), (29) and (42)
- FINRA Rules 0150, 2010, 2241, 2242, 2320, 4370, 5240, 5250, 5270, 5280, 5310, 5320, 6420 and 6710
- NASD Rules 1021, 1022, 1031, 1032 and 1050
- SEA Regulation NMS
- SEC Regulation AC

Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment. Comments must be received by April 9, 2018.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Note: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[3]

Background and Discussion

A number of FINRA rules do not apply to government securities or other exempted securities.[4] FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities) lists the FINRA rules[5] that expressly apply to transactions in, and business activities relating to, exempted securities, including government securities[6] (other than municipal securities[7]).

In August 2016, the SEC's Division of Trading and Markets, in consultation with the staff of the U.S. Department of the Treasury, requested that FINRA undertake a comprehensive review of its rulebook to identify existing FINRA rules that exclude or do not clearly apply to U.S. Treasury securities (or government securities more generally), and to assess the continuing validity for such exclusions.[8] In response, FINRA undertook a review of its rulebook for this purpose.[9]

As a result of its review, FINRA identified several rules that apply to exempted securities, including government securities (other than municipal securities), but that are not currently listed in FINRA Rule 0150. These include rules that generally apply to the activities of all FINRA members, without regard to the type of products they sell, such as FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information).[10]

In assessing the application of its rules to government securities, FINRA identified several rules that would benefit from additional industry comment. Specifically, as discussed below, FINRA is requesting comment on the implications of expressly applying FINRA Rules 2242, 5240, 5250, 5270, 5280 and 5320 as well as NASD Rules 1032(f), 1032(i) and 1050 to government securities, including U.S. Treasury securities. FINRA is also requesting comment on the implications of applying FINRA Rule 5320 and NASD Rules 1032(f) and 1050 to other types of debt securities, in addition to government securities.

FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports)

FINRA Rule 2242 governs conflicts of interest in connection with the publication of debt research reports and public appearances by debt research analysts. The rule defines "debt research report" to mean any written communication that includes an analysis of a debt security or issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision. The rule defines "debt security" to mean any security as defined in Section 3(a)(10) of the Exchange Act but excludes, among other securities, U.S. Treasury securities.

In general, FINRA Rule 2242 requires firms to implement policies and procedures to identify and manage research-related conflicts of interest. Among other things, the policies must restrict or, in some cases, prohibit investment banking and sales and trading and principal trading personnel from the supervision and compensation determination of debt research analysts and research budget determinations. The rule further prohibits promises of favorable research and analyst participation in solicitation of investment banking business and road shows. The rule also requires disclosure of investment banking relationships and other material conflicts of interest, such as personal and firm ownership of a subject company's securities and principal trading of those securities. In addition, the rule specifies the prohibited and permissible interactions between the debt research personnel and sales and trading and principal trading personnel.

In many ways, FINRA Rule 2242 mirrors FINRA Rule 2241 (Research Analysts and Research Reports), the equity research rule, with respect to debt research distributed to retail investors. However, unlike FINRA Rule 2241, the rule also exempts from many of its provisions and all of the specific disclosure requirements debt research that is distributed only to eligible institutional investors from which the firm has obtained consent to receive the less protected research.

In explaining the exclusion of U.S. Treasury securities from FINRA Rule 2242, FINRA stated that it was reticent to become involved with direct obligations of the United States.[11] However, FINRA differentiated agency securities, which are subject to FINRA Rule 2242, noting that it already required reporting of transactions in those securities to the Trade

Reporting and Compliance Engine (TRACE).[12] That distinction has since disappeared as FINRA, with the encouragement of the U.S. Department of the Treasury, now requires reporting of trades in U.S. Treasury securities to TRACE. FINRA also notes that FINRA Rule 2242 currently applies to research reports on foreign sovereign securities since many of the conflicts that rule addresses are present with respect to research on those securities. Further, the SEC's Regulation AC does not exclude U.S. Treasury securities from its certification requirements.

Questions

1. FINRA Rule 2242 governs conflicts of interest in connection with the publication of debt research reports and public appearances by debt research analysts. Is the nature of conflicts related to research on U.S. Treasury securities similar to those related to other debt securities? Is the magnitude of conflicts related to research on U.S. Treasury securities more than, less than or the same as those associated with other debt securities?
2. If FINRA Rule 2242 applied to U.S. Treasury securities, firms would be required to establish and implement policies and procedures to identify and manage conflicts of interest if they prepare research on U.S. Treasury securities that does not qualify for an exception to the definition of "debt research report." What are the associated costs of establishing and implementing such policies and procedures? What are the implementation challenges that member firms may face, such as challenges relating to walling off research analysts in U.S. Treasury securities from the government securities trading desk? Are associated costs and implementation challenges similar for small and large member firms?
3. FINRA understands that there are existing regulations by the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System on the auction process for U.S. Treasury securities. Given such regulations, would an additional layer of regulation be necessary? What would be the direct and indirect impacts of such additional layer of regulation?
4. Are there any other potential costs associated with extending the rule to U.S. Treasury securities?
5. What are the potential benefits of extending the rule to U.S. Treasury securities? Who would potentially be receiving the benefits?

FINRA Rule 5280 (Trading Ahead of Research Reports)

FINRA Rule 5280(a) states that no member firm shall establish, increase, decrease or liquidate an inventory position in a security or derivative of such security based on non-public advance knowledge of the content or timing of a research report in that security. FINRA Rule 5280(b) requires a member firm to establish, maintain and enforce policies and

procedures reasonably designed to restrict or limit the information flow between research department personnel, or other persons with knowledge of the content or timing of a research report, and trading department personnel, so as to prevent trading department personnel from utilizing non-public advance knowledge of the issuance or content of a research report for the benefit of the firm or any other person.

The objective of this rule is to prevent an unfair trading advantage for a firm or select customers based on knowledge of non-public research department information that is intended for a broader audience of customers. The rule, therefore, aims to ensure that where a firm chooses to provide information from its research department to its customers that may result in a transaction, it must give those customers priority in acting on the information vis-à-vis the member firm's own trading or that of select customers.

As FINRA noted in the proposed rule change adopting FINRA Rule 5280 and in an FAQ published in March 2016,[13] because of the differing objective of FINRA Rule 5280, the definition of research report in the rule is not only intended to apply to both debt and equity research reports, but also to be broader than the definitions of "research report" and "debt research report" in FINRA Rules 2241 and 2242, respectively. Instead, it captures any written information from the research department that a reasonable person would expect to result in a transaction based on that information. Thus, for example, whereas FINRA Rules 2241 and 2242 exclude research reports distributed to fewer than 15 persons, those communications would be covered by FINRA Rule 5280.

Questions

1. The rule currently applies to debt and equity research reports as defined in FINRA Rules 2241 and 2242 as well as to any written information from the research department that a reasonable person would expect to result in a transaction based on that information. Is there any reason to exclude research reports relating to government securities from the scope of the rule?
2. What are the potential costs, including the costs associated with establishing policies and procedures regarding information barriers, and potential benefits of expressly extending the rule to government securities?

FINRA Rule 5240 (Anti-Intimidation/Coordination)

FINRA Rule 5240 generally prohibits member firms and their associated persons from coordinating prices (including quotations) and trades or trade reports with any other person, asking or directing a member firm to alter a price, and attempting, directly or indirectly, to improperly influence any other person. The rule's prohibition includes but is not limited to behavior such as attempts to influence a member firm or associated person to adjust or maintain a price or quotation or other conduct that retaliates against or discourages the activities of another market maker or market participant.

The rule is designed to prevent behavior that could impair the fair and orderly functioning of the market by prohibiting specific conduct that is inconsistent with just and equitable principles of trade.[14] FINRA's policy concerning unlawful coordination and retribution or retaliatory conduct was originally codified by FINRA (then NASD) in 1997 as NASD IM-2110-5 (Anti-Intimidation/Coordination).[15] NASD noted at that time that it believed the conduct covered by the rule was already prohibited by then-NASD Rule 2110 (now FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)), which requires member firms to observe high standards of commercial honor and just and equitable principles of trade. However, NASD adopted the specific prohibitions of IM-2110-5 as part of an undertaking that NASD agreed to in response to a 1996 SEC report on the activities of certain Nasdaq market makers that impeded price competition in the Nasdaq market.[16] FINRA then adopted the language of IM-2110-5 without material change in FINRA Rule 5240 in 2009 as part of FINRA's effort to develop its consolidated rulebook.[17]

The rule identifies seven types of business activity by a firm that would not be prohibited, provided such activity is otherwise in compliance with all applicable law: (1) unilaterally setting its own bid or ask in a security at a bona fide price in a bona fide quantity; (2) unilaterally setting its own dealer spread, quote increment or quantity of shares for its quotations; (3) communicating its own bid or ask or bona fide prices or quantities in which it is willing to buy or sell in order to negotiate for or agree to a purchase or sale; (4) communicating its own bid or ask or bona fide prices or quantities in which it is willing to buy or sell to a person to retain that person as an agent or subagent for the member firm or its customer, and to negotiate for or agree to the purchase or sale; (5) underwriting; (6) taking unilateral action or making unilateral decisions regarding which market maker it will trade with and the relevant terms as long as such action is not otherwise prohibited by the rule; and (7) delivering an order to another member firm for handling.

Questions

1. The rule is not currently limited to equity securities. However, priced quotes are not as prevalent in the debt markets as in the equities markets, and there is not a "consolidated tape" of transactions. Are the policy goals underlying the rule—promoting price competition and preventing unlawful coordination, retribution and retaliatory conduct—still equally important in the context of debt securities, including government securities? Is there a risk of harm from price coordination or collusion in the government securities markets?
2. If the rule were extended to government securities, what would be the practical impacts? Would there be a need for any exceptions to the requirements, for example for primary dealers in the government securities market? If so, why?
3. What are the potential costs and benefits of expressly extending the rule to government securities?

FINRA Rule 5250 (Payments for Market Making)[18]

FINRA Rule 5250 prohibits member firms and their associated persons from accepting any payment or other consideration, directly or indirectly, from an issuer (or an issuer's affiliate or promoter), for publishing a quotation,[19] acting as a market maker or submitting an application in connection therewith. The rule contains exceptions that permit a firm to accept: (1) payments for bona fide services, including but not limited to investment banking services; (2) reimbursement of registration and listing fees; and (3) payments provided for under the effective rules of a national securities exchange.

The rule is designed to assure that member firms act in an independent capacity when publishing a quotation or making a market in an issuer's securities. FINRA's policy concerning payments for market making was originally set forth in *Notice to Members 75-16* and later codified as NASD Rule 2460 (now FINRA Rule 5250) in 1997.[20] Among other things, FINRA (then NASD) recognized that firms generally have considerable latitude and freedom to make or terminate market-making activities and was concerned that payments by an issuer to a market maker could influence a firm's decision to make a market. In particular, the existence of undisclosed, private arrangements between market makers and an issuer or its promoters may make it difficult for investors to ascertain the true market for the securities.[21]

Questions

1. The rule is not currently limited to equity securities. The rule may have limited applicability to government securities where the "issuer" of such securities is the U.S. government, such as in the case of U.S. Treasury securities. However, the rule may have applicability to other types of government securities, such as government-sponsored enterprise issues, or possibly in the context of payments by a "promoter," which is broadly defined to include, among others, employees, advisors and any other person with a similar interest in promoting the entry of quotations or market making in an issuer's securities. Are payments for market making a meaningful concern in the context of the government securities market?
2. What are the potential costs and benefits of expressly extending the rule to government securities?

FINRA Rule 5270 (Front Running of Block Transactions)

General Prohibition

FINRA Rule 5270 prohibits trading ahead of customer block transactions. Specifically, the rule prohibits trading, while in possession of material, non-public market information concerning an imminent customer block transaction, in the same security that is the subject of the block transaction as well as any "related financial instrument."[22] The reverse

is also true: When the imminent block transaction involves a related financial instrument, the rule prevents trading in the underlying security. The rule applies to trading ahead orders for: (1) any account in which a member firm or a person associated with a firm has an interest; (2) any account with respect to which the member firm or associated person exercises investment discretion; or (3) accounts of customers or affiliates of the firm when the customer or affiliate has been provided with the material, non-public market information concerning the imminent block transaction by the firm or associated person. FINRA Rule 5270 provides that the trading prohibitions in the rule apply until the time the information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete.

Although FINRA Rule 5270 applies to most debt securities, it does not currently apply to block transactions involving government securities, which include U.S. Treasury securities.[23] However, in the rule filing to adopt FINRA Rule 5270, FINRA noted that it has long been FINRA's view that front running conduct of the type contemplated by FINRA Rule 5270 in a government security would be prohibited pursuant to FINRA Rule 2010 requiring that member firms observe high standards of commercial honor and just and equitable principles of trade.[24] Thus, although general standards of just and equitable principles of trade prohibit firms from trading in front of a customer block order in government securities to benefit the firm, this type of trading activity is not currently subject to the more detailed and specific provisions in FINRA Rule 5270.

Supplementary Material

FINRA Rule 5270 includes five separate Supplementary Material provisions addressing different aspects of the rule.

- **Knowledge of Block Transactions.** Supplementary Material .01 provides that the prohibitions in the rule may include transactions that are executed based upon knowledge of less than all of the terms of the block transaction, so long as there is knowledge that all of the material terms of the transaction have been or will be agreed upon imminently.
- **Publicly Available Information.** Supplementary Material .02 provides guidance on when information is deemed to be "publicly available" for purposes of the rule and states that information will be considered "publicly available" when it is disseminated via a last sale reporting system or other similar system and only when the entire block transaction has been completed and publicly reported.
- **Examples of Block Transactions.** Supplementary Material .03 provides that, in the context of equity securities, a transaction involving 10,000 shares or more of a security or a related financial instrument overlying such number of shares is "generally deemed to be a block transaction." The Supplementary Material notes, however, that a transaction of fewer than 10,000 shares could be considered a block transaction.

- **Permitted Transactions.** Supplementary Material .04 lists several types of transactions that would generally not violate FINRA Rule 5270, including transactions that the firm can demonstrate are unrelated to the material, non-public market information received in connection with the customer order (such as where information barriers exist, transactions related to prior customer orders, and transactions to correct errors or offset odd-lot orders) and transactions undertaken for the purpose of fulfilling or facilitating the execution of the customer order.
- **Front Running of Non-Block Transactions.** Supplementary Material .05 notes that, although the prohibitions in FINRA Rule 5270 are limited to imminent block transactions, front running of other types of orders that place the financial interests of the member firm or associated person ahead of those of its customer, or the misuse of knowledge of an imminent customer order, may violate other FINRA rules, including FINRA Rules 2010 and 5320, or provisions of the federal securities laws.

Questions

1. The rule is not currently limited to equity securities. If the rule were extended to government securities, would any modifications to the rule be necessary, including to the restrictions on the trading of "related financial instruments," in light of the unique characteristics of the government securities market and the use of government securities as part of larger trading strategies? Are these concerns true across all types of government securities, or are they more significant for certain types of government securities (*e.g.*, "on-the-run" U.S. Treasury securities)?
2. If the rule were extended to government securities, should FINRA define, or provide guidance on, the types or sizes of transactions in government securities that could be considered "block transactions" for purposes of the rule? What is considered a typical block transaction in the government securities market? Is this the same across all government securities or is it different for different categories of government securities?
3. Would extending the rule to government securities have an impact on firms' hedging activities or on transactions that are undertaken involving government securities to facilitate other transactions?
4. What are the potential costs, including the costs associated with establishing policies and procedures regarding information barriers and modifying trading systems, and potential benefits of extending the rule to government securities? Are there operational and business challenges associated with such extension of the rule?
5. Would extending the rule to government securities have an impact on member firms' ability to execute workup trades?[25]

FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders)

General Prohibition

FINRA Rule 5320 generally addresses a firm's obligations with respect to handling customer orders in an equity security when also trading proprietarily in the same security. Specifically, the rule prohibits a member firm from trading for its own account in a security on the same side of the market at a price that would satisfy a customer order in the same security, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

If a member firm trades proprietarily at a price and size that would satisfy a pending customer order in an equity security, a firm would not violate the rule if it "cures" the trading ahead by immediately executing the customer order up to the size and at the same or better price at which it traded for its own account. FINRA has also provided guidance on the timeframe required to meet the "immediately" aspect of the cure obligation (*i.e.*, within one minute of the execution of the proprietary transaction).

The rule also requires that a member firm have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of FINRA Rules 5310 (Best Execution and Interpositioning) and 5320, and a firm further must ensure that such methodology is consistently applied.

Exceptions

FINRA Rule 5320.01 (Large Orders and Institutional Account Exceptions) provides an exception for large-sized customer orders and customer orders from an institutional account, if the member firm has provided the customer clear and comprehensive disclosure at account opening and annually thereafter that it may trade proprietarily at prices that would satisfy the customer order and provides the customer a meaningful opportunity to opt in to the rule's protections. Under the exception, a "large order" in an equity security is an order of 10,000 shares or more (unless such orders are less than $100,000 in value).

FINRA Rule 5320.02 (No-Knowledge Exception) generally provides firms with an exception for proprietary trading activity that occurs in a separate trading unit where the firm utilizes information barriers that prevent that trading unit from obtaining knowledge of customer orders held at another trading unit. For NMS stocks, all proprietary trading units may be walled off pursuant to the exception, whereas, for OTC equity securities, only non-market making desks may be walled off. Firms relying on the no-knowledge exception are required to comply with FINRA's Order Audit Trail System (OATS) reporting rules by providing a unique identifier on order information where information barriers are in place at departments within the firm where orders are received or originated.

FINRA Rule 5320.03 (Riskless Principal Exception) generally provides that the prohibitions of the rule would not apply to a member firm's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of an order from a customer. Among other things, the exception is conditioned upon member firms submitting a contemporaneous regulatory report identifying the trade as "riskless principal." The firm also must have in place policies and procedures requiring, among other things, that the customer order was received prior to the offsetting principal transaction, that the offsetting principal transaction is at the same price as the customer order (exclusive of any markup or markdown, commission equivalent or other fee), and that the securities be allocated to a riskless principal or customer account in a consistent manner within 60 seconds of execution. Member firms also must have supervisory systems in place that produce records that enable the firm and FINRA to reconstruct accurately, readily, and in a time-sequenced manner all facilitated orders for which the firm relies on this exception.

FINRA Rule 5320.04 (ISO Exception) provides firms with an exception under certain circumstances for proprietary trading resulting from an intermarket sweep order (ISO) routed in compliance with Rule 600(b)(30)(ii) of SEC Regulation NMS where the customer order is received after the firm routed the ISO. ISO orders are specific to trading in NMS stocks and are not applicable to trading in debt securities.

FINRA Rule 5320.05 (Odd Lot and Bona Fide Error Transaction Exceptions) provides an exception for a firm's proprietary trade to (1) offset a customer order that is in an amount less than a normal unit of trading; or (2) correct a bona fide error.

Other Provisions

FINRA Rule 5320.06 (Minimum Price Improvement Standards) prescribes the minimum amount of price improvement necessary for a member firm to execute an order on a proprietary basis when holding an unexecuted limit order in that same security without violating the rule's requirements. This provision is intended to prevent firms from "pennying" their customer order by trading ahead at a price in a very small increment better than the customer order. It also relies on best bid and offer (BBO) quotation information for calculation of the minimum amount of price improvement required for lower priced securities.

FINRA Rule 5320.07 (Order Handling Procedures) requires that: (1) a firm must make every effort to execute a marketable customer order that it receives fully and promptly; (2) a firm that is holding a marketable customer order that has not been immediately executed must make every effort to cross such order with any other order received at a price that is no less than the best bid and no greater than the best offer; and (3) in the event a firm is holding multiple orders on both sides of the market that have not been executed, the firm must make every effort to cross or otherwise execute such orders in a manner that is reasonable and consistent with the objectives of the rule and with the terms of the orders.

Finally, FINRA Rule 5320.08 (Trading Outside Normal Market Hours) provides that member firms generally may limit the life of a customer order to the period of normal market hours of 9:30 a.m. to 4:00 p.m. ET; however, if the customer and firm agree to the processing of the customer's order outside normal market hours, the protections of the rule shall apply to that customer's order(s) at all times the customer order is executable by the firm.

Questions

1. The rule is currently limited to equity securities. Should FINRA consider extending the rule to debt securities, including government securities, corporates and other types of TRACE-eligible securities? Are the conflicts related to the prohibition against trading ahead of customer orders in equity securities similar to those for debt securities?
2. If the rule were extended to debt securities, to what universe of debt securities should it apply—*e.g.*, would "TRACE-Eligible Security," as defined in FINRA Rule 6710 (Definitions), be the appropriate universe?[26]
3. The rule currently requires firms to have a written methodology governing the execution and priority of all pending orders in equity securities. Are there any concerns with applying this requirement to debt securities?
4. If the rule were extended to debt securities, what timeframe should be considered "immediately" within which a member firm must execute a customer order in a debt security following a proprietary trade by the firm under paragraph (a) of FINRA Rule 5320 (for equities, "immediately" means within one minute of the execution of the proprietary transaction)? In addition, should the timeframe to be considered "immediately" differ depending upon the type of debt security at issue (*e.g.*, a U.S. Treasury security versus a corporate bond, a securitized product or other type of debt security)?
5. If the rule were extended to debt securities, is an exception for institutional accounts sufficient or should an exception for large orders also be adopted? If so, what is the appropriate minimum par value for an order in a debt security to be considered a "large order" and, therefore, not due protection under FINRA Rule 5320 (subject to the disclosure and opt-in conditions of the exception)? Should the "large order" threshold amount differ for different types of debt securities?
6. If the rule were extended to debt securities, should the no-knowledge exception be available for any proprietary desk, whether market-making or non-market-making?[27]
7. If the rule were extended to debt securities, is a riskless principal exception useful for member firms in the debt context? If the riskless principal exception were to apply to debt securities, use of the exception would be subject to the policy and procedures and supervisory systems conditions that exist for equity securities. However, instead of a 60-second allocation timeframe, is 15 minutes more appropriate for all types of debt securities? Are there any other distinctions that should be drawn in the operation of

a riskless principal exception for different types of debt securities? Would a "riskless principal" capacity type in TRACE reporting be useful in connection with a riskless principal exception?

8. FINRA notes that the concept of round and odd lots differ for debt and equities (*e.g.*, in the debt market, trades in less than 100 bonds are common). If the rule were extended to debt securities, should the odd lot exception not apply to debt for this reason? The exception for bona fide errors could be applicable to debt securities. Is this distinction appropriate?

9. If the rule were extended to debt securities, should any additional exceptions be made available for debt securities?

10. If the rule were extended to debt securities, the order handling provisions of Supplementary Material .07 would, at a minimum, be modified such that the best bid and offer crossing requirement (*i.e.*, that a member firm make every effort to cross a marketable customer order that has not been immediately executed with any other order received at a price that is no less than the best bid and no greater than the best offer) would not apply to debt securities because best bid and offer information is not widely available for debt securities. The full and prompt execution requirement and the requirement regarding multiple orders would apply. Is this approach to order handling appropriate for debt securities?

11. If the rule were extended to debt securities, should the rule prescribe a minimum amount of price improvement necessary for a member firm's proprietary trade in a debt security not to be considered trading ahead of a customer limit order? Is this provision necessary to prevent firms from "pennying" their customer order by trading ahead at a price in a very small increment better than the customer order? Should a minimum price improvement amount be prescribed for certain types of debt securities but not others? If so, please explain. The current minimum price improvement provision calculation approach relies on best bid and offer quotation information for lower-priced securities. What would be an appropriate methodology for determining a minimum price improvement amount for debt securities, given that best bid and offer quotation information is not widely available? When placed, are limit orders used differently in the debt market or do they operate differently? Are priced orders used more for certain types of debt securities than others?

12. Trading in debt securities does not observe the same normal market hours as equity securities. Moreover, uniform normal market hours do not exist for debt securities. For example, the Treasury market is a 24-hour market and platforms that trade debt securities may operate according to differing schedules. In addition, TRACE system hours generally run from 8:00 a.m. ET through 6:29:59 p.m. ET. Thus, if the rule were extended to debt securities, should the rule's protections apply to a customer order at all times the customer order is executable by the member firm?

13. If the rule were extended to debt securities, are any other modifications to the rule necessary in light of the unique characteristics of debt securities, the market for debt securities, and the current regulatory framework for debt securities, which have not been addressed above? If so, please explain.
14. Are there potential impacts on firms' ability to provide services to clients on an agency basis, or to engage in principal trading activity, in U.S. Treasury securities?
15. What are the potential costs and benefits of extending the rule to debt securities? What are the potential direct and indirect impacts of extending the rule in such a manner? Would firms potentially adopt a different compliance regime and alter business practices because of such extension?
16. What are the potential impacts on trading behavior and liquidity provision by member firms? How likely are clients to be impacted by any potential change in trading behavior?

NASD Rule 1032(f) (Securities Trader)

Currently, associated persons engaged in trading are subject to different representative-level qualification and registration requirements depending on whether the trading activity involves an equity or a debt security. Specifically, associated persons engaged in equity trading are subject to the qualification and registration requirements of NASD Rule 1032(f), whereas associated persons engaged in debt trading are subject to the qualification and registration requirements of NASD Rules 1032(a) (General Securities Representative), 1032(e) (Limited Representative—Corporate Securities) or 1032(g) (Limited Representative—Government Securities), as applicable.

By way of background, in 1995, FINRA (then NASD) became concerned about the escalating number of rule violations by associated persons trading in the equity securities markets. Subsequently, in 1998, NASD adopted NASD Rule 1032(f) with the view that better training and qualification of individuals engaged in equity trading was necessary. Thus, the rule has historically applied to equity or equity-like securities, but not debt securities in general.

Pursuant to NASD Rule 1032(f), each associated person of a member firm who is included within the definition of "representative" in NASD Rule 1031 (Registration Requirements) is required to register as a Securities Trader if, with respect to transactions in equity (including equity options), preferred or convertible debt securities[28] effected otherwise than on a securities exchange, such person is engaged in proprietary trading, the execution of transactions on an agency basis or the direct supervision of such activities.[29] The rule provides an exception from the registration requirement for any associated person whose trading activities are conducted principally on behalf of an investment company that is registered with the SEC pursuant to the Investment Company Act of 1940 and that controls, is controlled by, or is under common control with the member firm. Individuals registering as Securities Traders must pass the Securities Trader qualification examination (Series 57).

Unlike associated persons engaged in equity trading, associated persons engaged in debt trading are not required to pass a specific qualification examination or to register as traders. Rather, associated persons who are included within the definition of "representative" in NASD Rule 1031 and who are trading government securities are required to register as General Securities Representatives or Government Securities Representatives and pass the General Securities Representative qualification examination (Series 7) or the Government Securities Representative qualification examination (Series 72), respectively.[30] In addition, associated persons who meet the definition of "representative" and who are trading other types of debt, such as corporate debt, are required to register as General Securities Representatives or Corporate Securities Representatives and pass the Series 7 or the Corporate Securities Representative qualification examination (Series 62), respectively.[31]

The principal-level qualification and registration requirements for associated persons supervising trading also vary depending on whether the trading activity involves an equity or a debt security. Paragraph (a)(6) of NASD Rule 1022 (Categories of Principal Registration) currently requires that each associated person who is included within the definition of "principal" in NASD Rule 1021 (Registration Requirements) with supervisory responsibility over the securities trading activities described in NASD Rule 1032(f) register as a Securities Trader Principal.[32] To qualify for registration as a Securities Trader Principal, an individual must be registered as a Securities Trader and pass the General Securities Principal qualification examination (Series 24). However, associated persons functioning as principals responsible for supervising debt trading currently are required to register as General Securities Principals and pass the Series 24 examination,[33] provided that if their activities are limited solely to the supervision of government securities trading, they may instead register as Government Securities Principals.[34]

The debt market constitutes a significant portion of the overall securities market and includes numerous complex product types with unique attributes. Moreover, debt securities are subject to specific laws, rules and regulations, which may require specialized knowledge. For instance, member firms engaged in over-the-counter secondary market transactions in eligible fixed income securities are required to report such transactions to TRACE, which has distinct reporting requirements and conventions.

Questions

1. The rule does not currently apply to associated persons who are engaged in the trading of debt securities or their supervisors. Should FINRA extend the existing qualification and registration requirements for Securities Traders to associated persons who are engaged in the trading of debt securities, including the trading of government securities, or in the direct supervision of such activities? Alternatively, should FINRA adopt a separate qualification examination and registration category for associated persons engaged in debt trading and their direct supervisors?

2. How likely are potential costs to be passed on to associated persons or clients? Are individuals likely to be discouraged from associating with a member firm in a capacity that requires registration? Would a potential increase in the compliance costs lead to any competitive disadvantages for member firms, as some non-FINRA debt dealers would not be subject to similar registration requirements?
3. Is there a need for a more specialized qualification requirement, such as an expanded Series 57 or a new examination, for debt traders? Would the costs of such requirements be passed on to associated persons or customers? Would some individuals be discouraged from associating with a member firm in a capacity that requires registration based on such requirements? Are there increased compliance costs associated with such requirements and would such costs lead to competitive disadvantages for firms (to the extent that some non-FINRA debt dealers would not be subject to similar requirements)? What are the other costs of such requirements on firms' compliance and supervisory systems, including on supervisors and principals responsible for supervising debt trading? Should associated persons who are currently registered and engaged in debt trading be grandfathered or provided other relief, from any new requirements?

NASD Rule 1032(i) (Limited Representative – Investment Banking)

NASD Rule 1032(i) requires each person associated with a member firm who is engaged in specified investment banking activities to register as an Investment Banking Representative and to pass the Series 79 qualification examination. The requirement is triggered if the individual's activities involve:

- advising on or facilitating debt or equity securities offerings through a private placement or a public offering, including but not limited to origination, underwriting, marketing, structuring, syndication, and pricing of such securities and managing the allocation and stabilization activities of such offerings; or
- advising on or facilitating mergers and acquisitions, tender offers, financial restructurings, asset sales, divestitures or other corporate reorganizations or business combination transactions, including but not limited to rendering a fairness, solvency or similar opinion.

The rule provides exceptions to the registration requirement for persons whose activities involve only retail or institutional sales and trading activities, advising on or facilitating placement of direct participation program securities (as those activities are defined in the registration requirements for Direct Participation Programs Representatives), or effecting private securities offerings (as those activities are defined in the registration requirements for Private Securities Offering Representatives). There is currently no exception for investment banking activities related to government securities.

The purpose of this registration provision was to create a core competency examination requirement more specifically tailored to the activities of investment bankers than the more generalized Series 7 qualification examination previously required of most investment bankers. To that end, the triggers for this registration requirement encompass a broad range of investment banking activities, including advising on or facilitating all types of debt and equity offerings, other than the narrow exceptions noted above.[35]

Questions

1. The rule currently applies to debt securities offerings. What are the significant differences between investment banking activities in the government securities market and investment banking activities in the corporate debt space? Are there any specific rules and regulations relating to investment banking activities in the government securities market that would warrant excluding such activities from the scope of the rule?
2. What are the potential costs and benefits of extending the rule to government securities? How likely are member firms going to be required to register additional associated persons?

NASD Rule 1050 (Registration of Research Analysts)

NASD Rule 1050 requires all persons associated with a member firm who are to function as research analysts to register with FINRA as such and pass the Series 86 (Analysis) and Series 87 (Regulatory Administration) qualification examinations.[36] For the purposes of the rule, "research analyst" means an associated person whose primary job function is to provide investment research and who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report. Registration as a General Securities Representative is currently a prerequisite to taking the research analyst qualification examinations.

The rule became effective in 2004, when only an equity research conflict of interest rule existed. In July 2016, FINRA Rule 2242, a dedicated debt research conflict of interest rule became effective. However, as FINRA noted in proposing FINRA Rule 2242 and in an FAQ after its approval,[37] NASD Rule 1050 was not amended and applies only to equity research analysts. FINRA also noted that it was considering whether a similar requirement should apply to debt research analysts.[38]

Questions

1. The rule does not currently apply to debt research analysts or their supervisors. Should FINRA extend the existing qualification and registration requirements for equity research analysts to debt research analysts, including associated persons primarily responsible for the substance of research reports on government securities? Is the

current content covered on the Series 86 appropriate for debt research analysts, or should the content be modified? Alternatively, should FINRA adopt a separate qualification examination and registration category for debt research analysts?

2. Is there is a need for a qualification and registration requirement for debt research analysts? Would some individuals be discouraged from associating with a member firm in a capacity that requires registration based on such requirements? What is the impact of such requirements on firms' compliance and supervisory systems, including on supervisors and principals responsible for supervising debt research analysts? Are there any associated persons primarily responsible for the substance of debt research reports that should be exempted from such requirements based on their job function? Should associated persons who are currently registered and functioning as debt research analysts be grandfathered or provided other relief, from such requirements?

Other Exempted Securities

The rules listed in FINRA Rule 0150 are applicable to transactions in, and business activities relating to, other exempted securities[39] (excluding municipal securities), depending on the context of a particular rule. For example, FINRA Rule 2320(g) (Member Compensation), which is listed in FINRA Rule 0150, is applicable to group variable contracts that are exempted securities, but not to government securities.

Question

1. As a general matter, are there any potential issues with applying the rules discussed in this *Notice* to other exempted securities (excluding municipal securities)?

Potential Economic Impact of the Proposals

The rules discussed above are intended to create benefits for member firms and the investing public. Specifically, these rules, among other things, mitigate the research-related conflicts of interest, prevent an unfair trading advantage for a firm or select customers based on knowledge of non-public research department information, maintain fair and orderly functioning of the markets, assure that member firms act in an independent capacity when publishing a quotation or making a market, and set the qualification and registration requirements for individuals engaged in trading or investment banking activities. However, FINRA also acknowledges that these rules may currently impose compliance costs on member firms, in the form of staffing costs, costs associated with establishing and implementing policies and procedures, fees associated with qualification examinations and registration as well as supervision and monitoring costs. In some instances, compliance with these rules may limit a member firm's ability to transact in a security at a given time and there may be an opportunity cost associated with the restrictions.

The anticipated costs and benefits associated with expressly applying these rules to government securities and, in some cases, to debt securities more broadly, may be substantially the same or may differ in important ways from the securities already covered by the rules. FINRA invites comment generally and in connection with the questions above on any economic impacts that might be associated with the application of the rules discussed in this *Notice* to government securities, including U.S. Treasury securities, and other debt securities more broadly. FINRA understands that the application of these rules to government securities and other debt securities may potentially have both direct and indirect impacts on member firms, the government securities market, customers and the investing public. FINRA requests that commenters provide a discussion of the types (direct vs. indirect) and sources (*e.g.*, compliance, staffing or technology) of potential costs and benefits wherever possible.

Request for Comments

FINRA seeks comments on the implications of expressly applying the rules discussed in this *Notice* to government securities, including U.S. Treasury securities, and, in some cases, to debt securities more broadly. In responding to the questions above or in providing general comments, FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible.

Endnotes

1. FINRA Rule 2242 currently applies to debt securities, including most government securities. However, the rule expressly excludes U.S. Treasury securities.

2. The SEC approved a proposed rule change to adopt NASD Rules 1032(f), 1032(i) and 1050 as FINRA Rules 1220(b)(4) (Securities Trader), 1220(b)(5) (Investment Banking Representative) and 1220(b)(6) (Research Analyst), respectively, in the consolidated FINRA rulebook. The consolidated FINRA registration rules have been approved by the SEC and will become effective October 1, 2018. *See* Securities Exchange Act Release No. 81098 (July 7, 2017), 82 FR 32419 (July 13, 2017) (Order Approving File No. SR-FINRA-2017-007); *Regulatory Notice 17-30* (October 2017) (SEC Approves Consolidated FINRA Registration Rules, Restructured Representative-Level Qualification Examinations and Changes to Continuing Education Requirements).

3. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

4. The term "exempted securities" is defined in Section 3(a)(12) of the Securities Exchange Act of 1934 (SEA or Exchange Act).

5. Some of these rules have been expressly approved by the Securities and Exchange Commission (SEC). *See, e.g.*, Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39). Others were filed with the SEC for immediate effectiveness. *See, e.g.*, Securities Exchange Act Release No. 61747 (March 19, 2010), 75 FR 15470 (March 29, 2010) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2010-010).

6. The term "government securities" is defined in Section 3(a)(42) of the Exchange Act.

7. The term "municipal securities" is defined in Section 3(a)(29) of the Exchange Act.

8. *See* letter from Stephen Luparello, Director, Division of Trading and Markets, SEC, to Robert W. Cook, President and Chief Executive Officer, FINRA, dated August 19, 2016, available at *https://www.sec.gov/divisions/marketreg/letter-to-finra-regulation-of-us-treasury-securities.pdf*.

9. *See* letter from Robert W. Cook, President and Chief Executive Officer, FINRA, to Stephen Luparello, Director, Division of Trading and Markets, SEC, dated October 17, 2016, available at *https://www.sec.gov/divisions/marketreg/letter-from-finra-regulation-of-us-treasury-securities.pdf*.

10. FINRA is considering filing a proposed rule change with the SEC to codify these rules under FINRA Rule 0150(c).

11. *See* Securities Exchange Act Release No. 73623 (November 18, 2014) 79 FR 69905, 69922 (November 24, 2014) (Notice of Filing of File No. SR-FINRA-2014-048).

12. *See id.*

13. *See* Securities Exchange Act Release No. 59254 (January 15, 2009) 74 FR 4271, 4272 (January 23, 2009) (Order Approving File No. SR-FINRA-2008-054) and Research Rules Frequently Asked Questions (FAQ), Applicability of Rule 5280 (Trading Ahead of Research Reports), Q1, posted March 4, 2016, available at *http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq#5280*.

14. *See* Securities Exchange Act Release No. 59119 (February 2, 2009) 74 FR 6335 (February 6, 2009) (Order Approving File No. SR-FINRA-2008-061).

15. *See* Securities Exchange Act Release No. 38845 (July 17, 1997) 62 FR 39564 (July 23, 1997) (Order Approving File No. SR-NASD-97-37).

16. *See* Order Approving File No. SR-FINRA-2008-061, *supra* note 14.

17. *See id.*

18. In November 2017, FINRA published *Regulatory Notice 17-41* announcing its retrospective rule review to assess the effectiveness and efficiency of FINRA Rule 5250 and soliciting comment on the rule. Upon completion of its assessment, FINRA staff will consider appropriate next steps, which may include some or all of the following: modifications to the rule, updated or additional guidance, administrative changes or technology improvements, or additional research or information gathering.

19. "Quotation" is defined under FINRA Rule 5250 as (1) any bid or offer at a specified price with respect to a security, (2) any indication of interest by a member firm in receiving bids or offers from others for a security, or (3) an indication by a firm that it wishes to advertise its general interest in buying or selling a particular security.

20. *See Notice to Members 75-16* (February 20, 1975) and Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (Order Approving File No. SR-NASD-97-29).

21. As stated in the SEC's approval order, "If payments. . . were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace." Securities Exchange Act Release No. 38812, 62 FR at 37107.

22. A "related financial instrument" is defined as an option, derivative, or other financial instrument that overlies a security that is the subject of an imminent block transaction if the value of the underlying security is materially related to, or otherwise acts as a substitute for, such security, as well as any contract that is the functional economic equivalent of a position in such security.

23. *See Regulatory Notice 12-52*, n. 9 (December 2012).

24. *See* Securities Exchange Act Release No. 67774 (September 4, 2012), 77 FR 55519, 55520 n.6 (September 10, 2012); *see also Regulatory Notice 12-52*, n. 9 and *Notice to Members 96-66* (October 1996).

25. In a "workup," the execution of a marketable order opens a short time window where participants can transact additional volume at the same price. For a detailed description of the workup process, please *see http://libertystreeteconomics.newyorkfed.org/2015/08/the-evolution-of-workups-in-the-us-treasury-securities-market.html*.

26. FINRA would also clarify the meaning of "equity security" under the rule. Specifically, FINRA would replace the term "equity security" with the terms "NMS stock," as defined in Rule 600 of SEC Regulation NMS, and "OTC equity security," as defined in FINRA Rule 6420, which would make clear that the rule does not apply to options.

27. The unique identifier requirement would not apply because debt securities would not be subject to the OATS reporting rules.

28. FINRA included convertible debt securities under the rule because, under specific conditions, convertible debt securities trade similarly to equity securities.

29. The rule also requires that associated persons primarily responsible for the design, development or significant modification of algorithmic trading strategies (or responsible for the day-to-day supervision or direction of such activities) register as Securities Traders.

30. *See* NASD Rules 1032(a) and (g).

31. *See* NASD Rules 1032(a) and (e).

32. The corresponding consolidated registration rule is FINRA Rule 1220(a)(7) (Securities Trader Principal). *See supra* note 2.

33. *See* NASD Rule 1022(a)(1).

34. Individuals registering as Government Securities Principals are not subject to a principal qualification examination. However, they are required to satisfy the General Securities Representative or Government Securities Representative prerequisite registration. *See* NASD Rule 1022(h) (Limited Principal—Government Securities).

35. In addition, NASD Rule 1022(a)(1)(B) currently requires that a General Securities Principal with responsibility over the investment banking activities specified in NASD Rule 1032(i) also satisfy the Investment Banking Representative registration requirement. The corresponding consolidated registration rule is FINRA Rule 1220(a)(5) (Investment Banking Principal). *See supra* note 2.

36. Associated persons supervising the conduct of equity research analysts are also subject to specific principal-level qualification and registration requirements. Specifically, NASD Rule 1022(a)(5) requires persons who supervise the conduct of "research analysts" under NASD Rule 1050 to register as Research Principals. The corresponding consolidated registration rule is FINRA Rule 1220(a)(6) (Research Principal). *See supra* note 2. Currently, a Research Principal is required to be registered as a General Securities Principal and pass either the Series 87 or the Supervisory Analyst qualification examination (Series 16).

37. *See* Securities Exchange Act Release No. 73623 (November 18, 2014) 79 FR 69905 (November 24, 2014) (Notice of Filing of File No. SR-FINRA-2014-048) and Research Rules Frequently Asked Questions (FAQ), Registration Requirements, Q1, posted March 4, 2016, available at *http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq#registration*.

38. *See* Research Rules Frequently Asked Questions (FAQ), Registration Requirements, Q1, posted March 4, 2016, available at *http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq#registration*.

39. Exempted securities, other than government securities, include, for example, interests or participations in specified qualified plans and insurance company contracts, interests or participations in specified church plans, pooled income funds, and various collective investment vehicles that are excluded from the definition of "investment company" under Section 3(c) of the Investment Company Act, and such other securities as determined by SEC rule.