Client Alert

May 27, 2014

FINRA Clarifies Reporting Requirements for Tier 1 Capital Securities

Three Types of Hybrid Securities Subject to Classification and Reporting Changes

For some time now, there has been confusion regarding the appropriate trade reporting for certain hybrid securities. Hybrid securities, such as non-cumulative perpetual preferred securities and depositary shares, have certain features typically associated with equity securities and certain features typically associated with debt securities. Traditionally, trust preferred securities and non-cumulative perpetual securities were reported to FINRA's Trade Reporting and Compliance Engine ("TRACE") system (as debt securities).

Following the enactment of the Dodd-Frank Act and the implementation of the Basel III capital rules in the United States, trust preferred securities and other "innovative" hybrid securities that once qualified for favorable regulatory capital treatment have generally been phased out. Banks have instead come to rely upon the issuance of non-cumulative preferred stock to raise Tier 1-qualifying capital. Increased issuance activity may have led FINRA to revisit the manner in which hybrid securities transactions should be trade reported.

Despite the debt-like characteristics of these securities, certain non-cumulative perpetual preferred securities offerings and depositary share offerings were reported as equity securities, rather than through the TRACE system. Many investors in these securities focused principally on their debt-like features. In fact, certain institutional investors that have been significant buyers of these securities are limited in their ability to purchase equity securities.

On May 16, 2014, FINRA issued an interpretation clarifying the classification and trade reporting requirements of the following three hybrid securities (the "Covered Hybrid Securities"):[1]

- unlisted depositary shares having a liquidation preference or cash redemption price of $1,000 or more that is a fractional interest in a non-convertible, preferred security;
- unlisted non-convertible, preferred securities having a liquidation preference or a cash redemption price of $1,000 or more; and
- unlisted capital trust and trust preferred securities.

[1] *See* FINRA Regulatory Notice 14-23 (May 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p507406.pdf.

According to the recent interpretation issued by FINRA, FINRA will now deem the Covered Hybrid Securities as TRACE-Eligible Securities subject to the reporting requirements under the FINRA Rule 6700 series and the Covered Hybrid Securities will be excluded from the definition of OTC Equity Security. This means that depositary shares and non-cumulative perpetual preferred securities that are directed at institutional investors (i.e., unlisted) will continue to be viewed as "debt" securities for FINRA trade reporting purposes.

However, all other preferred securities and depositary shares representing fractional interests in preferred securities will be classified as OTC Equity Securities subject to the reporting requirements of FINRA Rule 6622.[2] As a result, small denomination "retail" non-cumulative preferred securities or depositary shares (i.e., listed) will be viewed as "equity" securities for FINRA reporting purposes.

FINRA also stated that the interpretation applies solely to Covered Hybrid Securities not listed on an equity facility of a national securities exchange consistent with the FINRA Trade Reporting Notice issued on February 22, 2008.[3] In addition, FINRA noted that the interpretation also applies to unlisted American Depository Receipts (ADRs) on Covered Hybrid Securities in the same manner in which it applies to the underlying Covered Hybrid Security.

Although the interpretation provides some clarity regarding FINRA trade reporting for "institutional" non-cumulative perpetual preferred securities and depositary shares, some practical concerns still remain. For example, it remains to be seen whether "retail" preferred securities will continue to be included in the major debt indices since they are now classified as equity by FINRA. In addition, the SEC has long treated preferred and hybrid securities that behave more like debt securities than equity securities and also qualify for Tier 1 capital treatment as debt securities.[4] However, it is not clear whether the SEC's characterization of such securities will continue given that such securities must now be FINRA trade reported as equity securities.

Effective Date

The change in reporting requirements for the Covered Hybrid Securities will be effective starting on June 16, 2014. However, prior to that effective date, firms requesting the set-up of a new hybrid security may comply with the new reporting requirements.

The interpretation also provides a list of Covered Hybrid Securities that will be moved from ORF to TRACE reporting on June 16, 2014.

[2] Under FINRA Rule 6622, firms must report over-the-counter ("OTC") transactions in OTC Equity Securities to the OTC Reporting Facility ("ORF").
[3] *See* FINRA Trade Reporting Notice, "FINRA Announces Modifications to the TRACE System Relating to Certain Securities with Equity CUSIPs and Reminds Firms of Their Reporting Obligations Regarding Equity-Linked Notes and Convertible Debt" (February 22, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038031.pdf.
[4] For example, in *BBVA Privanza International Limited and Banco Bilbao Vizcaya Argentaria, S.A.*, the SEC did not take action under Rule 14e-1(b) under the Securities Exchange Act of 1934, as amended, in connection with a tender offer of non-cumulative guaranteed preference shares which had debt-like characteristics and were to be priced based on a fixed spread pricing methodology. The tender offer was intended to be substantially similar to the tender offers covered by SEC no-action letters relating to the use of fixed spread pricing methodologies for non-convertible, investment grade debt tender offers. The preference shares also were not listed or traded on any U.S. stock exchange or automated quotation system. *See* SEC No-Action Letter, BBVA Privanza International Limited and Banco Bilbao Vizcaya Argentaria, S.A. (December 23, 2005).

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