SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90646; File No. SR-FINRA-2020-034)

December 11, 2020

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Modify TRACE Dissemination Protocols for Agency Pass-Through MBS or SBA-Backed ABS Traded in Specified Pool Transactions

I. Introduction

On October 15, 2020, 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 modify the Trade Reporting and Compliance Engine ("TRACE") dissemination protocols for Agency Pass-Through Mortgage-Backed Securities or Small Business Administration ("SBA")-Backed Asset-Backed Securities traded in Specified Pool Transactions. The proposed rule change was published for comment in the Federal Register on October 29, 2020.[3] The Commission received one comment letter in support of the proposed rule change.[4] This order approves the proposed rule change.

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 90264 (October 23, 2020), 85 FR 68607 (October 29, 2020) ("Notice").

4 See Letter from Wendell J. Chambliss, Vice President and Deputy General Counsel, Mission, Legislative and Regulatory Affairs, Legal Division, Freddie Mac, to J. Matthew DeLesDernier, Assistant Security, Commission, dated November 18, 2020 ("Freddie Mac Letter").

II. Description of the Proposal

FINRA commenced public dissemination of Specified Pool Transactions in 2013 after the Commission approved FINRA's proposal to do so in 2012.[5] FINRA's rules define a "Specified Pool Transaction" as a transaction in an Agency Pass-Through Mortgage-Backed Security ("Agency Pass-Through MBS")[6] or an SBA-Backed Asset-Backed Security ("SBA-Backed ABS")[7] requiring the delivery at settlement of a pool or pools that is identified by a unique pool identification number at the Time of Execution.[8] As described in the FINRA-2012-042 Approval, when disseminating information of a Specified Pool Transaction, FINRA does not identify the specific bond transacted by disclosing its CUSIP code.[9] Instead, FINRA disseminates more general information about the bond and the pool underlying the bond,

5 See Securities Exchange Act Release No. 68084 (October 23, 2012), 77 FR 65436 (October 26, 2012) ("FINRA-2012-042 Approval"). This filing provided for, among other things, public dissemination of transactions in Agency Pass-Through Mortgage-Backed Securities traded in specified pools and transactions in SBA-Backed Asset-Backed Securities traded in specified pools or to be announced, and reduced the reporting timeframe for such transactions.

6 FINRA Rule 6710(v) defines an "Agency Pass-Through MBS" as "a type of Securitized Product issued in conformity with a program of an Agency as defined in [FINRA Rule 6710(k)] or a Government-Sponsored Enterprise ('GSE') as defined in [FINRA Rule 6710(n)], for which the timely payment of principal and interest is guaranteed by the Agency or GSE, representing ownership interest in a pool (or pools) of mortgage loans structured to 'pass through' the principal and interest payments to the holders of the security on a pro rata basis."

7 FINRA Rule 6710(bb) defines an "SBA-Backed ABS" as "a Securitized Product issued in conformity with a program of the SBA, for which the timely payment of principal and interest is guaranteed by the SBA, representing ownership interest in a pool (or pools) of loans or debentures and structured to 'pass through' the principal and interest payments made by the borrowers in such loans or debentures to the holders of the security on a pro rata basis."

8 See FINRA Rule 6710(x).

9 See FINRA-2012-042 Approval, 77 FR at 65437.

including approximations of information widely used to project cash flows and prepayment rates of the underlying mortgages, such as loan-to-value ("LTV") information.[10]

Under its public dissemination protocol for Specified Pool Transactions, FINRA groups the pools underlying the transacted bonds into cohorts, using data elements that are integral to describing and valuing the bonds based on these pools, such as the LTV ratio. The cohort groupings are established using rounded or truncated figures for the underlying data elements, so that numeric values within each cohort can be understood within defined ranges. Each cohort is assigned a unique identification number — the Reference Data Identifier ("RDID"). After a member reports a Specified Pool Transaction to TRACE, FINRA disseminates the corresponding RDID in lieu of disseminating the transacted bond's CUSIP code. The underlying data elements that correspond to each RDID are made available to members through the TRACE system.[11] FINRA rounds or truncates certain cohort groupings to reduce the risk that the specific bond traded and the market participant that engaged in the transaction might be identified.[12]

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[10] See id. FINRA stated that, in developing the approach to public dissemination described in the FINRA-2012-042 Approval, it considered industry feedback, including concerns that dissemination of the CUSIP code in a Specified Pool Transaction might result in information leakage regarding trading strategies, positions, and other sensitive information, which could negatively impact trading interest and liquidity in the market for these securities. See Notice, 85 FR at 68607.

[11] FINRA uses the following ten data elements to form the RDID cohorts that describe the security traded in a Specified Pool Transaction: (1) Issuer; (2) Product Type; (3) Amortization Type; (4) Coupon; (5) Original Maturity; (6) Weighted Average Coupon ("WAC"); (7) Weighted Average Maturity ("WAM"); (8) Weighted Average Loan Age ("WALA"); (9) Current Average Loan Size ("ALS"); and (10) Original LTV. For example, RDID #A1234 might represent: (1) Issuer = FNMA; (2) Product Type = Co-Op; (3) Amortization Type = ARM; (4) Coupon = 2.0; (5) Original Maturity = 360; (6) WAC = 2.5; (7) WAM = 200; (8) WALA = 160; (9) ALS = 100; and (10) Original LTV = 50. See id., 85 FR at 68607-08.

[12] Currently, the rounding and truncation conventions that are used for Specified Pool Transactions are the following: (1) Coupon - Rounded down to the nearest quarter percentage point – e.g., an interest rate of 5.12% is rounded to 5%; (2) Original Maturity

FINRA believes "that the transaction information disseminated through TRACE should provide investors with sufficient information to assess the value and price of a security, which for Securitized Products, includes information necessary to make assumptions about cash flows and prepayment rates."[13] The elements described above are intended to provide market participants with the information necessary to perform such an analysis.[14]

FINRA stated that, since commencing public dissemination of Specified Pool Transactions, it has continued to evaluate the relevant market and the value of the information disseminated to market participants.[15] As a result of these efforts, which included discussions with market participants, FINRA is now proposing changes to the LTV rounding convention used in the public dissemination of Specified Pool Transactions.[16] Specifically, FINRA proposes to create more granular cohorts for LTV to increase the precision of the information regarding the LTV of the pool traded. In place of the current LTV rounding convention, which is rounded

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- Rounded up to the nearest 10 – e.g., an original maturity of 358 months is rounded to 360 months; (3) WAC - Truncated to a single decimal – e.g., a WAC of 7.13% is truncated to 7.1%; (4) WAM - Rounded down to the nearest 10 – e.g., a WAM of 87 months is rounded to 80 month; (5) WALA - Rounded up to the nearest 10 – e.g., a WALA of 163 months is rounded to 170 months; (6) ALS - Rounded down to the nearest 25 – e.g., an ALS of 113 (i.e., $113,000 average loan size) is rounded to 100 (i.e., $100,000 average loan size); and (7) LTV - Rounded down to the nearest 25 – e.g., an original LTV of 72% is rounded to 50%. See id., 85 FR at 68608.

13 Id.

14 See id.

15 See id.

16 FINRA has not proposed changes to the rounding or truncation conventions utilized for the other data elements.

down to the nearest 25%, FINRA will organize the cohorts such that each cohort represents the LTV as the upper limit of the applicable category, as follows:

1. for an LTV up to 20%, the cohorts would represent the LTV as 20% (such that an original LTV of 12% would be shown as 20%);
2. for an LTV between 21% and 40%, the cohorts would represent the LTV as 40% (such that an original LTV of 21% would be shown as 40%);
3. for an LTV between 41% and 60%, the cohorts would represent the LTV as 60% (such that an original LTV of 60% would be shown as 60%);
4. for an LTV between 61% and 80%, the cohorts would represent the LTV as 80% (such that an original LTV of 70% would be shown as 80%);
5. for an LTV between 81% and 93%, the cohorts would represent the LTV as 93% (such that an original LTV of 90% would be shown as 93%);
6. for an LTV between 94% and 100%, the cohorts would represent the LTV as 100% (such that an original LTV of 100% would be shown as 100%);
7. for an LTV between 101% and 120%, the cohorts would represent the LTV as 120% (such that an original LTV of 105% would be shown as 120%); and
8. for an LTV of 121% or greater, the cohorts would represent the LTV as 121+ (such that an original LTV of 125% would be shown as 121+).

Thus, as a result of the proposed rule change, FINRA will disseminate the LTV ratio cohorts at 20%, 40%, 60%, 80%, 93%, 100%, 120%, and 120%+. FINRA stated that, in developing the new LTV approach, it sought to balance the goal of making more detailed information available to the market against the potential risk of identifying the particular security being traded and the market participant that engaged in the transaction.[17] FINRA believes that the new LTV rounding convention is a "measured change" that will provide more granular and meaningful information on the LTV of the Specified Pool Transaction, which should increase the value of the disseminated information to market participants.[18] FINRA also anticipates that the new cohorts will improve how disseminated TRACE data reflects the role of LTV ratios in MBS valuations.[19]

FINRA has stated that it will announce the effective date of the rule change in a Regulatory Notice to be published no later than 60 days following a Commission approval, and the effective date will be no later than 270 days following publication of that Regulatory Notice.[20]

III. Discussion and Commission Findings

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[21] In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,[22] which requires, among other things,

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17 See Notice, 85 FR at 68608.

18 See id., 85 FR at 68609.

19 See id., 85 FR at 68608. FINRA stated, for example, that separating pools with LTV ratios at or below 80% from those with LTV ratios of 81% or higher delineates the pools with mortgages that might require mortgage insurance from those that might not require mortgage insurance. See id. Similarly, FINRA believes that the cohorts for LTV ratios of 81% or more are more consistent with the way mortgage originators view loan characteristics and the way that the market determines pricing. See id.

20 See id., 85 FR at 68609.

21 In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

22 15 U.S.C. 78o-3(b)(6).

that FINRA rules 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.

When it issued the FINRA-2012-042 Approval, the Commission found that the protocols for publicly disseminating Specified Pool Transactions proposed by FINRA—specifically, eschewing dissemination of CUSIP codes and instead providing more generic information about the bond transacted and the underlying pool—were consistent with the Act.[23] The Commission stated that the dissemination protocols for the specified data elements "strike an appropriate balance between providing meaningful post-trade transparency and, at the same time, reducing the potential for 'reverse engineering' of transaction data that could permit identification of a market participant and/or its trading strategy."[24] The Commission also noted that FINRA could in the future determine to propose dissemination of additional data elements that it believes would improve transparency for Specified Pool Transactions.[25]

FINRA is now proposing to revise the dissemination protocol for Specified Pool Transactions by increasing the precision of the LTV cohort groupings. In place of the current rounding convention used for LTV (i.e., rounded down to the nearest 25%), FINRA will utilize eight cohorts, with each cohort representing the LTV as the upper limit of the applicable grouping. FINRA believes that the tighter bands around LTVs will benefit market participants by increasing the value of price information as it relates to LTV.[26]

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23 See FINRA-2012-042 Approval, 77 FR at 65437-38.

24 Id., 77 FR at 65437.

25 See id., 77 FR at 65438.

26 See Notice, 85 FR at 68610.

The Commission finds that the current proposal is consistent with the Act because it represents a measured adjustment to the overall public dissemination protocols for Specialized Pool Transactions that the Commission previously found consistent with the Act in the FINRA-2012-042 Approval. Establishing additional cohorts utilizing the proposed LTV thresholds appears reasonably designed to provide market participants and other market observers with more useful information about the transacted bonds while minimizing the potential for adverse market impact. The Commission notes that it received no comments suggesting that the proposal would have adverse market impact; the one comment letter received on the proposal was supportive.[27] Moreover, FINRA has represented that it will continue to evaluate the market for Specified Pool Transactions and evaluate the conventions that it uses for disseminating information on these transactions.[28] The Commission also notes that, under this proposal, FINRA members will not incur any administrative burdens to report transactions differently; the creation and distribution of the new LTV cohorts will be performed by FINRA through the TRACE system.

Pursuant to Section 19(b)(5) of the Act,[29] the Commission consulted with and considered the views of the Treasury Department in determining to approve the proposed rule change. The

27 See Freddie Mac Letter at 1 (stating that "[a]dopting the proposed approach of segmenting LTV ratios into eight categories would align TRACE data with pooling practices and would enhance market transparency while maintaining sufficient anonymity").

28 See Notice, 85 FR at 68610.

29 15 U.S.C. 78s(b)(5) (providing that the Commission "shall consult with and consider the views of the Secretary of the Treasury prior to approving a proposed rule filed by a registered securities association that primarily concerns conduct related to transactions in government securities, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor").

Treasury Department indicated its support for the proposal.[30] Pursuant to Section 19(b)(6) of the Act,[31] the Commission has considered the sufficiency and appropriateness of existing laws and rules applicable to government securities brokers, government securities dealers, and their associated persons in approving the proposal. As discussed above, the proposed rule change appears reasonably designed to improve the value to market participants and other market observers of the LTV information disseminated for Specified Pool Transactions.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[32] that the proposed rule change (SR-FINRA-2020-034) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[33]

J. Matthew DeLesDernier ,

Assistant Secretary.

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30 E-mail from Treasury Department staff to Michael Gaw, Assistant Director, Division of Trading and Markets, Commission (November 30, 2020).

31 15 U.S.C. 78s(b)(6).

32 15 U.S.C. 78s(b)(2).

33 17 CFR 200.30-3(a)(12).