

April 7, 2015

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Fixed Income Quotation Information and Alternative Trading Systems
Regulatory Notice 15-03

Dear Ms. Asquith:

FOLIOfn Investments, Inc. ("Folio") appreciates the opportunity to express its views regarding FINRA's proposal to require alternative trading systems ("ATSs") to submit certain quotation information relating to fixed income securities ("Quotation Information") to FINRA for regulatory purposes. We support FINRA's efforts to strengthen its oversight of the fixed income markets and appreciate FINRA's need to have information necessary to conduct surveillance of market activities. However, we strongly believe that the proposal is overly broad in its application to the trading of certain Minor Notes and Privately Placed Debt (each as defined below). Stated simply, the goals sought to be attained by FINRA through the proposal are inapposite to the trading of these securities on ATSs. Moreover, we are concerned that the proposed reporting requirements will have a negative impact on smaller investors, businesses, and ATSs. Therefore, as discussed below, we recommend that FINRA exclude from the proposal the reporting of Quotation Information involving secondary market trading in Minor Notes and Privately Placed Debt.

Folio is a self-clearing broker-dealer that engages in a range of business lines via web interface, including equity trading, mutual fund sales, facilitation of unlisted securities offerings, and securities clearing and custody.¹

A. Comments on Rule Proposal

FINRA's proposal is in keeping with the Securities and Exchange Commission's ("SEC") recent focus on regulatory initiatives "to enhance the public availability of pre-trade pricing information in the fixed income markets, particularly with respect to smaller retail-size orders."² SEC Chair White emphasized, however,

¹ For more information about Folio, see www.folioinvesting.com.

² Speech, SEC Chair Mary Jo White, "Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors," (June 20, 2014) (available at <http://www.sec.gov/News/Speech/Detail/Speech/1370542122012>).

that any regulatory proposal in this area needs to be “carefully calibrate[d] … to best achieve its goals and minimize unintended consequences.”³ We believe that the broad applicability of this proposal to Privately Placed Debt and Minor Notes used by small businesses, not-for-profits and individuals will be unduly burdensome to ATSs that permit trading in such securities and lead to significant negative consequences for the issuers of such securities, without providing the intended regulatory benefits. Therefore, we urge FINRA to minimize the negative effects of the proposal by specifically excluding Minor Notes and Privately Placed Debt, and the ATSs that facilitate trading in such securities, from Proposed Rule 45XX.

1. Significant Costs without Regulatory Benefits

We believe that applying the reporting requirements to Minor Notes and Privately Placed Debt (collectively, “Selected Debt Securities”) would not achieve FINRA’s regulatory goals with regard to those securities, while negatively impacting the primary and secondary markets for such Selected Debt Securities. Therefore, we believe that Proposed Rule 45XX should be amended to specifically exclude Selected Debt Securities.

a. FINRA’s Regulatory Goals Inapposite to Privately Placed Debt and Minor Notes

The proposal states that FINRA seeks ongoing access to Quotation Information for fixed income securities for several reasons. First, FINRA seeks to strengthen its overall regulation⁴ and, particularly, its automated surveillance of fixed income trading by requiring additional information on prevailing market conditions.⁵ FINRA also believes that such information may help it detect compliance violations and potentially manipulative behaviors more effectively.⁶ The proposal also is intended to enable FINRA to assess the existing information available to ATS subscribers and to more fully explore the implications of the differences between the fixed income and the equities markets.⁷ Although the proposal would limit the use of Quotation Information for surveillance and regulatory purposes, FINRA also wishes to capture such information for purposes of analyzing the potential value and feasibility of public dissemination of the information in the future.⁸

Folio notes that, while the proposal may help FINRA achieve these goals in the context of the trading of corporate bonds and other, traditional, fixed income securities by ATSs, it will be of no use when applied to the Selected Debt Securities.

³ *Id.*

⁴ FINRA Regulatory Notice 15-03 at 4.

⁵ *Id.* at 3.

⁶ *Id.* at 4.

⁷ *Id.*

⁸ *Id.*

Instead, the proposal will only impose significant costs on member firms seeking to provide some level of liquidity in the trading of these instruments. In doing so, it also will impose unnecessary and burdensome costs on the small businesses and individuals that rely on these novel financing mechanisms.

i. Minor Notes

We believe that FINRA's articulated goals for Proposed Rule 45XX are in apposite to Minor Notes. The term "Minor Notes" is intended to include fixed income securities in which the characteristics of the security are sufficiently unique that it is not objectively comparable to other fixed income securities in the market. Specifically, it would include corporate debt that is unrelated to the creditworthiness of the issuer, is not paid back with money earned by the future operations of the issuer, is not collateralized by the physical assets of the issuer, is issued as nonrecourse and is priced in a way that is wholly unrelated to any other fixed income security in the market.

Examples of Minor Notes are the peer-to-peer lending notes traded by Folio. Specifically, Folio has provided two web-based alternative trading systems (the "Note ATSS") for unaffiliated, non-FINRA members, Lending Club Corporation ("Lending Club") (since 2008) and, together, Prosper Marketplace, Inc. and Prosper Funding LLC (since 2009 and 2013, respectively) (Prosper Marketplace, Inc. and Prosper Funding LLC, together, "Prosper"). Lending Club and Prosper operate online marketplaces that facilitate loans to consumers and small businesses. On their websites, borrowers post loan listings for fixed-rate unsecured personal loans ranging from approximately \$1,000 to \$35,000 with three or five year terms. Investors, in turn, purchase notes issued by Prosper or Lending Club pursuant to prospectus under a continuous offering registered with the SEC, the proceeds from which fund the loans. The size of notes traded on the Note ATSS is determined based on the size of the loan to be funded and the number of investors that are willing to buy notes to fund the loan, with a minimum note size of \$25 and a maximum note size of \$35,000.⁹

We do not believe that applying Proposed Rule 45XX to Minor Notes will provide the expected regulatory benefits. For example, Minor Notes differ significantly from the types of corporate debt that are generally traded on fixed income ATSSs. As a result, we do not believe that the information collected will provide FINRA with useful data for crafting reporting or other regulations for the fixed income markets generally. First, unlike traditional corporate debt, Minor Notes generally are created to facilitate the financing needs of smaller borrowers,

⁹ See, e.g., Prospectus, Lending Club Member Payment Dependent Notes (Aug. 22, 2104) (available at <https://www.lendingclub.com/fileDownload.action?file=Clean As Filed 20140822.pdf&type=docs>) ("Lending Club Prospectus"); Prospectus, Prosper Funding LLC and Prosper Marketplace LLC (Dec. 5. 2014) (available at https://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2014-12-05.pdf) ("Prosper Prospectus").

rather than larger corporations. Minor Notes are not directly tied to the economics or creditworthiness of the issuer, but, rather, to the unique needs and financial circumstances of each underlying borrower, which may vary greatly. Second, the average size of trades in Minor Notes generally is quite small. For example, the average price per note traded on the Note ATSs for 2012 and 2013 was less than \$40 per note, and this average price remains consistent today. Third, the liquidity and frequency of trading in Minor Notes is even less than that of the average retail fixed income security. For example, in 2013, it took an average of approximately four days to sell a note on the Lending Club Note ATS with an offer price at or below par.¹⁰ Moreover, only approximately 2.5% of the notes traded on the Lending Club Note ATS during 2013 traded more than twice, and only 0.02% of the notes traded on the Lending Club Note ATS during 2013 traded more than five times. Fourth, Minor Notes generally are priced either at par or at a dollar value set by the Minor Note seller; the market for these notes is driven by individual investors, not by the quotes of dealers.¹¹ Fifth, with respect to the Minor Notes traded on the Note ATSs, the dollar value of each note is determined by the number of borrowers willing to fund the original loan, with a minimum note size of \$25, and is not dictated by or correlated with the broader debt market.

In addition, given the small size and infrequent trading of Minor Notes, as well as the individualized valuations of these securities, there is no value in regular automated surveillance of the trading of Minor Notes, and little chance of detecting manipulative activity or other similar violations from the collection of Quotation Information for these securities. Moreover, there is little point in evaluating the value of publicly disseminating Quotation Information in Minor Notes to the broader market when it is unlikely that Minor Notes would be traded on more than one ATS, or that there would be broader market interest in the pricing of Minor Notes.

ii. Privately Placed Debt

Similarly, applying the proposed rule to Privately Placed Debt would not assist FINRA in reaching any of its stated goals in proposing the rule. The term "Privately Placed Debt" includes unregistered, privately placed securities that meet the various factors outlined above in the discussion of the definition of Minor Notes. An example of such Privately Placed Debt includes the private debt offered by Community Development Financial Institutions ("CDFIs").¹² In addition to providing

¹⁰ Lending Club Prospectus at 13.

¹¹ The Prosper Note ATS also includes an auction feature that allows the seller to set a minimum price and buyers to bid higher for the note during pre-set window of time. The highest bidder wins the auction at the close of the auction window.

¹² A CDFI "is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding

the Note ATSs discussed above, Folio is developing technology to automate the process of offering private debt by CDFIs. We anticipate that there will be demand for a secondary market trading platform for such securities and, similar to the notes offered by Lending Club and Prosper, the debt issued by CDFIs is issued to generate funding for loans to borrowers (including not-for-profit enterprises, for community development activities and projects).

As noted above with respect to Minor Notes, we do not believe that FINRA's intended goals are relevant to Privately Placed Debt. Privately Placed Debt differs substantially from the more traditional forms of corporate debt, and, therefore, would not provide useful information for evaluating the differences between the fixed income and equity markets, or otherwise crafting reporting or other regulations for the fixed income markets generally. In addition, given the small/moderately liquid markets for Privately Placed Debt, which we anticipate will be largely focused on, for example, facilitating the sale of a note by one retail investor with an immediate need for liquidity to purchase a home or fund a child's college education to another retail investor, we do not believe that the benefit of seeking to detect potential violations through the proposed reporting requirements is warranted in light of the burdensome costs of collecting the Quotation Information. Moreover, given the pricing and size of, and smaller markets for, Privately Placed Debt, Privately Placed Debt is not the type of security that FINRA needs to monitor on a frequent and regular basis. Therefore, FINRA's regulatory purposes related to automated surveillance similarly are not applicable to Privately Placed Debt.

b. Significant Costs related to Privately Placed Debt and Minor Notes

We believe that the costs of reporting Quotation Information for the Selected Debt Securities would be significant (as discussed in more detail below). Requiring ATSs to comply with the proposed reporting requirements for the Selected Debt Securities would raise the costs for offering trading opportunities for these types of securities. In doing so, it would increase the costs for both borrowers seeking to raise funds and the investors interested in pursuing investment opportunities in such securities. As the SEC has noted, promoting the development of secondary markets is important for both the primary market and secondary markets for that security. "While a robust, liquid secondary market has benefits of its own, it also promotes the health of the primary offering market, which directly benefits small business issuers."¹³ Given the typically small size of the Selected Debt Securities

businesses in low-income areas. CDFIs include regulated institutions such as community development banks and credit unions, and non-regulated institutions such as loan and venture capital funds." See CDFI Certification, at http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=9. CDFIs are certified by the U.S. Department of the Treasury Community Development Financial Institutions Fund.

¹³ Speech, SEC Commissioner Daniel Gallagher, Opening Remarks to the 2014 Government-Business Forum on Small Business Capital Formation (Nov. 20, 2014) (available at

and the limited trading market for such securities, even potentially small increases in costs related to the Selected Debt Securities are likely to have a significant negative impact on both the primary and secondary markets for these securities.

c. Recommended Alternative

Because the application of the proposed reporting requirements to the Selected Debt Securities would create a significant burden with no regulatory benefit, we recommend that FINRA revise its proposal to expressly exclude Selected Debt Securities from the definition of TRACE-Eligible Securities.¹⁴ With such a change, the Proposed Rule would maximize the regulatory benefits of the proposal while minimizing the costs and burdens to small investors and borrowers, and the capital formation process for smaller businesses. FINRA would, of course, still have access to records of FINRA members relating to transactions in Selected Debt Securities through its regular examination process.¹⁵

If, however, FINRA determines not to exclude Selected Debt Securities from the definition of TRACE-Eligible Securities, we recommend, at a minimum, that FINRA delay the application of Proposed Rule 45XX to Selected Debt Securities. Because FINRA has determined to apply its proposal to a subset of TRACE-Eligible Securities (i.e., only agency and corporate debt securities) at the outset, it would be appropriate to delay the applicability of the proposal to Selected Debt Securities until FINRA has more experience with the rule and considers whether to expand Proposed Rule 45XX to cover those TRACE-Eligible Securities not yet covered by the proposal.

2. Negative Impact on Smaller Fixed Income ATSs

Under the proposed rule, the reporting requirement would apply to members with an ATS that has a Form ATS on file with the SEC.¹⁶ Therefore, this requirement would apply to both large and small ATSs alike. We believe, however,

<http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543507810>). See also Securities Exchange Act Rel. No. 64976 (July 27, 2011), 76 Fed. Reg. 46960, 47001 (Aug. 3, 2011) (SEC “acknowledges that participation in primary market offerings may be affected by changes in expectations about secondary market liquidity and price efficiency”).

¹⁴ We recognize that revising the definition of “TRACE-Eligible Securities” also would exclude the Selected Debt Securities from the requirements under FINRA’s TRACE reporting rules. See FINRA Rule 6700 Series. Given the unique nature of Selected Debt Securities, we also fully support specifically excluding Selected Debt Securities from the TRACE reporting requirements. As an alternative, however, FINRA also could consider permitting exemptions from the trade reporting requirements for ATSs that trade Selected Debt Securities pursuant to Rule 6731.

¹⁵ When it revised Rule 4522 to exclude TRACE-Eligible Securities from the weekly transaction reporting requirements for ATSs, FINRA recognized that, given the cost of the reporting requirements, direct requests regarding weekly transaction counts on an as-needed basis would provide sufficient information for regulatory purposes. Securities Exchange Act Rel. No. 71911 (Apr. 9, 2014).

¹⁶ Proposed FINRA Rule 45XX(a).

that the costs and burdens of the proposed reporting requirement are likely to unduly negatively affect smaller fixed income trading platforms and their willingness to commence and continue operating as ATSs. In fact, the costs and burdens of the proposed rule may force smaller broker-dealers, including those currently operating ATSs to facilitate trading in Selected Debt Securities, to use less efficient means of facilitating liquidity in these instruments to avoid qualifying as an ATS subject to the proposed rule. Therefore, we recommend that FINRA narrow the proposed reporting requirement to apply solely to larger ATSs.

We believe that the compliance costs associated with the proposal are significant. Proposed Rule 45XX requires that the ATSs report to FINRA Quotation Information, which is defined to include a long list of data about quotations, including (1) the party submitting the quotation and the party's capacity; (2) the CUSIP number or FINRA symbol of the quoted security; (3) the date, time, and duration (if applicable) of the quotation; (4) the actual or minimum size associated with the quotation; (5) the price, yield, or spread to benchmark, including information on the relevant benchmark, of the quotation as it was submitted by the party to the ATS; (6) the quotation as displayed to ATS subscribers; (7) whether the quotation was "subject" or firm; (8) the side of the quotation (buy/sell); and (9) whether the quotation was modified or cancelled and if so, the date and time of the modification or cancellation.¹⁷

To comply with the proposal, ATSs would be required to establish internal systems and processes for collecting and formatting Quotation Information as well as submitting Quotation Information to FINRA. Accordingly, ATSs would need to fund one-time development costs to build a reporting mechanism, as well as ongoing costs for operational support, monitoring and compliance. Smaller ATSs may not have the Quotation Information available in a format that is easily transferred to FINRA, thereby raising the need to alter their internal processes and systems to compile and report the information to FINRA. Such costs would disproportionately impact smaller ATSs, including those catering to smaller businesses and smaller investors.

In light of the above cost concerns and the concerns about the regulatory usefulness of the proposal (as discussed above), we recommend that FINRA apply the proposed reporting requirement solely to larger ATSs. Specifically, we would recommend that the reporting requirement apply to ATSs that meet some minimum trading threshold.

Focusing more significant regulatory requirements on larger ATSs parallels the approach taken by the SEC with regard to Regulation ATS. When it adopted Regulation ATS, the SEC specifically tailored the requirements to minimize the

¹⁷ Proposed FINRA Rule 45XX(b)(5).

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burdens on smaller ATSs.¹⁸ For example, to avoid “disproportionate burdens” on smaller ATSs, the SEC only required smaller ATSs to file a notice of operation and quarterly reports, maintain certain records, and refrain from using the terms “exchange” or “stock market” in its name. In contrast, the SEC applied the more significant and costly requirements related to (1) order display and execution access, (2) fair access, and (3) capacity, integrity and security solely to larger ATSs that meet certain trading volume thresholds.¹⁹ In doing so, the SEC reasoned that the benefits of applying these additional requirements to smaller ATSs were not sufficient to justify the associated costs.²⁰ We believe that the same reasoning applies here.

Moreover, as FINRA recognizes in its Regulatory Notice, the proposal does not apply to request for quote or RFQ platforms, where the great majority of fixed income trading takes place.²¹ Instead, FINRA has proposed a more limited and measured approach to begin to gather useful data for analyzing the fixed income markets. We believe that limiting the proposal to larger ATSs is fully in keeping with FINRA’s goal to gain some experience with a limited subset of the fixed income market. As a result, eliminating smaller ATSs from the reporting requirements would not substantially affect FINRA’s regulatory purpose.

B. Conclusion

As SEC Commissioner Gallagher has noted, “small business is the lifeblood of our economy and the primary engine of economic growth and job creation in this country.” Therefore, it is critical that FINRA carefully consider the needs of smaller businesses in adopting new rule changes. Accordingly, we recommend that FINRA tailor its rule proposal to minimize the burdens related to the Selected Debt Securities and smaller ATSs. With these changes, we believe that Proposed Rule 45XX would satisfy the Exchange Act requirement that FINRA’s rules be designed “to remove impediments to and perfect the mechanism of a free and open market,” as required by the Exchange Act.

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¹⁸ See Securities Exchange Act Rel. No. 40760 (Dec. 8. 1998), 63 Fed. Reg. 70844, 70905 (Dec. 22, 1988) (“ATS Release”).

¹⁹ See Rule 301(b)(3), (5) and (6).

²⁰ See, e.g., ATS Release at 70867.

²¹ See, e.g., Corporate Bond E-Trading: Same Game, New Playing Field, McKinsey & Company and Greenfield Associates (Aug. 2013).

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We appreciate the opportunity to provide comments on the proposed reporting requirement for fixed income ATSs. Please feel free to contact me at (703) 245-4848 or greene@folioinvesting.com if you have any questions or comments.

Sincerely,

Erica A. Green
Vice President & General Counsel