Chapman and Cutler LLP

Chapman Client Alert

August 29, 2016 Current Issues Relevant to Our Clients

SEC Seeks Comments on FINRA Rule Changes Requiring Bond Mark-ups/Mark-downs on Trade Confirmations

The Securities and Exchange Commission (the *"SEC"*) is seeking comments on proposed Financial Industry Regulatory Authority, Inc. (*"FINRA"*) rule changes that would require members to disclose bond mark-ups and mark-downs on retail customer trade confirmations. Specifically, if a member engages in a principal trade with a non-institutional customer in a corporate or agency debt security and the member also executes one or more offsetting principal transactions on the same day that meet or exceed the size of the customer's, the member would be required to disclose the member's mark-up or mark-down from the "prevailing market price" for the security on the customer confirmation. The SEC's request for comment and notice of the proposal is available here. A similar proposal by the Municipal Securities Rulemaking Board (the *"MSRB"*) related to municipal bonds is expected to be filed with the SEC in the near future, and we will publish a separate Client Alert once the SEC publishes that proposal.

Previous FINRA and MSRB Proposals

In late 2014, FINRA and the MSRB proposed to amend existing rules regarding customer trade confirmations to require disclosure of various pricing information to customers for certain "retail-sized" transactions in debt securities, but the pricing disclosure would not literally have included a dealer's mark-up/mark-down on the specific customer trade. Both proposals would have required dealers to provide additional reference trade price information on customer trade confirmations when the dealer executes any retail-sized transaction with a customer and also executes a transaction as principal with one or multiple parties for the same security within the same trading day. Under both proposals, a "retail-size" transaction would have meant a purchase or sale transaction with a customer of 100 bonds or less or bonds with a par/face amount of $100,000 or less. For more information regarding the initial FINRA and MSRB proposals, please see our November 2014 Client Alert available here.

In late 2015, FINRA and the MSRB both released revisions to their initial rule proposals. Among other things, the revised proposals replaced the size-based disclosure threshold with a retail customer standard, would permit firms to use alternate methodologies for calculating the "reference price" for more complex trade scenarios, would require firms to add a link to the Trade Reporting And Compliance Engine (*"TRACE"*) on the confirmation and provided additional exceptions from the requirements. The primary difference between the revised proposals was that the MSRB proposal specifically required disclosure of mark-ups and mark-downs while the FINRA pricing information disclosure would have required "reference price" disclosure that would not specifically be disclosure of a firm's mark-up or mark-down on the customer trade. For more information on the revised 2015 FINRA proposal, please see our October 2015 Client Alert available here, and for more information on the revised 2015 MSRB proposal, please see our September 2015 Client Alert available here.

The New FINRA Rule—Confirmation Disclosure of Mark-up/Mark-down

The SEC is seeking comments on revisions to FINRA Rule 2232 (Customer Confirmations). The revised rule would require member firms to disclose their specific mark-up or mark-down from the "prevailing market price" for a security in certain transactions with retail customers. The mark-up or mark-down would be calculated in compliance with Rule 2121 (Fair Prices and Commissions) and would be expressed both as a total dollar amount and as a percentage of the prevailing market price. In its SEC filing, FINRA noted that the proposal does not alter the requirements of Rule 2121 or otherwise intend to modify how firms calculate their mark-ups/mark-downs. For additional information on recent developments regarding mark-ups and mark-downs under existing FINRA and MSRB rules, see our Client Alerts here and here.

When Would Firms Need to Disclose Mark-ups/Mark-downs?

The revised rule would require mark-up/mark-down disclosure when a member firm effects a transaction in a corporate or agency debt security with a non-institutional customer on a principal basis. The disclosure would only be required if the member firm also purchased/sold the same security in one or more transactions on the same trading day in an aggregate size that equals or exceeds the size of the customer trade. For example, if a firm bought 100 bonds from various sources on a particular day and sold 100 of the same bonds to a retail customer that day, the firm would need to include mark-up disclosure on the retail customer trade confirmation. However, if the firm bought those 100 bonds on one day and sold the bonds to a retail customer the next day without any other transactions in those bonds on that day, the retail customer trade confirmation would not include any mark-up disclosure.

Retail Customers Only

The disclosure requirement is designed to apply to retail customers only. Specifically, the requirement would apply to transactions with a "non-institutional customer". Under the proposed amendments, a "non-institutional customer" means a customer with an account that is not an "institutional account" under FINRA Rule 4512(c). FINRA rules define "institutional account" to mean an account of (i) a bank, savings and loan association, insurance company or registered investment company; (ii) an investment adviser registered either with the SEC under the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (iii) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. Note that FINRA rules define the term "customer" to exclude a broker or dealer. Accordingly, the revised rule disclosure does not apply to inter-dealer trade confirmations.

Corporate and Agency Debt Securities Only

The disclosure requirement applies only to transactions in corporate and agency debt securities. The definitions of these securities in the revised rule generally align with definitions under the FINRA TRACE rules in FINRA Rule 6710. A "corporate debt security" is a U.S. dollar-denominated debt security issued by a U.S. or foreign private issuer, including securities offered pursuant to Rule 144A under the Securities Act of 1933, but does not include money market instruments or asset-backed securities. An "agency debt security" has the same definition as under FINRA TRACE rules.

Look-Through for Non-Arms-Length Affiliate Transactions

With respect to the offsetting principal trades, where a member buys from, or sells to, certain affiliates, the revised rule would require the member to "look through" the member's transaction with the affiliate to the affiliate's transaction with a third party in determining when the security was acquired and whether the "same trading day" requirement has been triggered. Specifically, the rule requires members to apply the "look through" where a member's transaction with its affiliate was not at arms-length. For this purpose, an "arms-length transaction" would be considered a transaction that was conducted through a competitive process in which non-affiliate firms could also participate (*e.g.*, pricing sought from multiple firms, or the posting of multiple bids and offers) and where the affiliate relationship did not influence the price paid or proceeds received by the member.

Exceptions for Functionally Separate Trading Desks and Fixed-Price Offerings

The proposed rule also contains two exceptions to the proposed disclosure requirement. First, if the offsetting same day firm principal trade was executed by a trading desk that is functionally separate from the firm's trading desk that executed the transaction with the customer, the principal trade by that separate trading desk would not trigger the disclosure requirement. Firms must have policies and procedures reasonably designed to ensure that the functionally separate principal trading desk through which the member purchase or member sale was executed had no knowledge of the customer transaction. For example, the exception would allow an institutional desk within a firm to service an institutional customer without necessarily triggering the disclosure requirement for an unrelated trade performed by a separate retail desk within the firm.

Second, the proposed rule would not apply if the member acquired the security in a fixed-price offering and sold the security to non-institutional customers at the same fixed-price offering price on the day the securities were acquired. In a fixed-price offering, the compensation paid to the firm, such as the underwriting fee, is paid for by the issuer and described in the prospectus.

What's Next?

You can submit comments to the SEC by submitting a hard copy, by using the SEC's internet comment form available under SR-FINRA-2016-032 at this link or by sending an email to rule-comments@sec.gov with File Number

SR-FINRA-2016-032 in the subject line. Comments must be received within 21 days from the date of publication of the filing in the Federal Register. If the SEC approves the rule change, FINRA will announce the effective date of the proposed rule change no later than 90 days following the approval, and the effective date will be no later than one year following the approval.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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