

Client Alert

Current Issues Relevant to Our Clients

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FINRA Revises Proposed Trade Confirmation Disclosure of Pricing Information in Retail Bond Transactions

The Financial Industry Regulatory Authority (“FINRA”) is requesting comment on a revised proposal to amend FINRA Rule 2232 governing trade confirmation disclosures. The amendments would require member firms to disclose a “reference price” on customer confirmations for principal transactions in corporate and agency debt securities with retail customers. The Regulatory Notice describing the revised proposal is available [here](#). The FINRA proposal follows a similar revised proposal by the Municipal Securities Rulemaking Board (“MSRB”) which would require firms to include mark-ups/mark-downs on trade confirmation disclosure. For more information on the MSRB’s proposed amendments see our Client Alert available [here](#). Both the MSRB and FINRA proposals respond to comments to prior proposals but differ somewhat in detail. For additional information about the prior proposals, please see our Client Alert available [here](#). The primary difference between the revised proposals is that the MSRB proposal would specifically require disclosure of mark-ups and mark-downs while the FINRA pricing information disclosure would not specifically be disclosure of mark-ups or mark-downs.

Prior MSRB and FINRA Proposals

In late 2014 FINRA and the MSRB proposed to amend existing rules regarding customer trade confirmations to provide disclosure of recent trade prices directly to customers for certain “retail-sized” transactions in debt securities. 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. Under FINRA and MSRB rules, the term “customer” does not include another broker-dealer. Accordingly, the prior proposals would not have applied to inter-dealer trade confirmations but would have applied to transactions with an institutional investor in an amount less than or equal to 100 bonds or \$100,000 par/face amount.

The initial FINRA proposal would require that a member firm provide disclosure if the member firm enters into a retail-sized transaction with a customer and on the same trading day enters into a transaction with another party as principal in the same security as the retail transaction. Under the initial proposal, the firm would have to disclose on the customer confirmation (i) the price to the customer; (ii) the price to the firm of the same-day trade (“Reference Price”); and (iii) the difference between those two prices. The revised proposal maintains the Reference Price requirements and (i) replaces the size-based disclosure threshold with a retail customer standard; (ii) permits firms to use alternate methodologies for calculating the Reference Price for more complex trade scenarios; (iii) requires firms to add a link to the Trade Reporting And

Compliance Engine (“TRACE”) on the confirmation; and (iv) proposes additional exceptions from the requirements.

When and What Would Firms Need to Disclose?

The FINRA disclosure requirement would be triggered when a member firm executes a principal transaction with one or multiple parties in the same security as a non-institutional customer transaction. The member’s principal transaction(s) must also occur within the same trading day and be in an amount that, in the aggregate, equals or exceeds the size of the non-institutional customer transaction. In the case of a sale to a customer, the proposal would apply to instances where the firm bought bonds as principal both prior to, and after, it sold bonds to the customer. The proposal would also apply to instances where the firm buys bonds from a customer and sells the same bonds as principal to another party on the same trading day. In that scenario, the proposal would apply to instances where the firm sold bonds as principal both prior to, and after, it bought bonds from the customer.

If the requirement is triggered, the firm would be required to disclose the following in the non-institutional customer’s trade confirmation:

- the price to the customer of the non-institutional customer’s trade;
- the member’s Reference Price;

- the differential between the price to the customer and the member's Reference Price; and
- a reference, and hyperlink if the confirmation is electronic, to the TRACE publicly available trading data for the bond.

Under the proposed amendments, a “non-institutional customer” means a customer account that is not an institutional account. 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 Securities and Exchange Commission 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.

What is a Firm's “Reference Price”?

Generally, the Reference Price must be the price of a same-day principal trade by the member in the same security. However, where a single principal trade is not the same size or greater than the customer trade or where there are one or more intervening principal trades between the same or greater size trades within the same trading day, the revised proposal would allow the member to use an alternative methodology to determine the Reference Price. The methodology would need to be an average weighted price of the member's same-day principal trades that either equal or exceed the size of the customer trade, or is otherwise derived from the price(s) of the member's same-day principal trades and communicates comparable pricing information to the customer. FINRA stated that an acceptable methodology could also include using the price of the last same-day transaction in the same securities or the price of the transaction closest in time to the customer transaction. The methodology would need to be consistently applied across the member's non-institutional customer base and clearly documented in the member's written policies and procedures.

Under the proposed amendments, for the purposes of establishing a Reference Price, a member firm is not required to consider a principal trade where:

- the member's principal transaction was executed by a trading desk that was functionally separate from the trading desk that executed the non-institutional customer order (as demonstrated through the firm's policies and procedures), including that the transactions and positions of the separate desk are not regularly used to source the retail transactions at the other desk;

- the member's principal trade was executed with an affiliate of the member, where the affiliate's position that satisfied this trade was not acquired on the same trading day; or
- the member acquired the security in a fixed-price offering and sold the security to non-institutional customers at the fixed price offering price on the day the securities were acquired. However, variable price offerings reported as secondary trades would trigger the proposed disclosure requirements.

If a firm's only principal transactions made on the same day and in the same securities as those in a non-institutional customer transaction are excluded under the provisions described above, the firm would not need to provide Reference Price disclosure in its trade confirmation. Alternatively, if the firm engaged in multiple transactions in the applicable security, the firm would need to review all of the non-excluded transactions to determine whether Reference Price disclosure is required under the proposed rule changes.

When is Reference Price Disclosure Not Required?

In certain instances, the amended proposal would allow member firms to elect to not disclose the Reference Price for a customer transaction or to disclose the Reference Price along with an explanation of any change in Reference Price. In order to make such an election, a member firm must have documented and be able to demonstrate that there was a material change in the price of the security between the time of the transactions used as the basis of the Reference Price and the time of the customer transaction. FINRA stated that this provision is not intended to be used when the price of the security has changed due to normal price fluctuations or general market volatility. FINRA indicated that member firms may use this provision when the material change in the price of the security has occurred due to a material event such as a credit downgrade or breaking news.

Comparing the MSRB and FINRA Revised Proposals

As noted above, the MSRB also published a notice soliciting comment on a revised proposal. The MSRB's proposed disclosure requirements differ from FINRA's in that the MSRB would require disclosure of the amount of the firm's mark-up (or mark-down) for certain retail customer transactions, rather than the Reference Price paid by the firm and the differential between the Reference Price and the price paid by the customer. Under the MSRB's proposal, the firm would be required to disclose its mark-up or mark-down if the firm traded as principal within two hours of the customer transaction. FINRA

believes its revised approach is likely to result in more consistent disclosures for a greater number of retail customers than the MSRB approach. FINRA also believes that its approach and the MSRB's mark-up disclosure approach would produce similar outcomes. One of the primary reasons for the MSRB's mark-up approach is that the MSRB believed that it would decrease the burden of compliance and focus on trade information already maintained and monitored by firms for fair pricing and best execution compliance. While similar in concept, the current FINRA proposal's Reference Price disclosure approach would not literally match up with a firm's mark-up/mark-down on a transaction as measured under FINRA Rule 2121.

The MSRB proposal contains a similar exclusion to FINRA's with regard to transactions by functionally separate trading desks. Conversely, the MSRB's proposal requires dealers to "look through" transactions with affiliated dealers to determine the relevant mark-up or mark-down to disclose. While the FINRA and MSRB revised proposals currently differ, FINRA indicated that both entities favor a coordinated approach. Accordingly, FINRA invited comments on the MSRB's proposal in comparison to FINRA's revised proposal and on whether the MSRB's proposal, or elements of the proposal, may be an appropriate alternative to FINRA's revised proposal.

Providing Comment

You may submit comments on the proposed FINRA rule changes on or before December 11, 2015. Comments on the FINRA proposal may be submitted by hard copy or via email at pubcom@finra.org.

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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