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FINRA Revises Markup/Commission Rule Proposal

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued a revised proposal to consolidate its rules governing markups, markdowns, commissions and fees. FINRA originally published a rule proposal in March 2011 that would consolidate and materially revise several NASD and NYSE rules. In response to comments received, FINRA is now proposing several changes to the revised proposal. This Client Alert focuses on differences from the original proposal. For additional information on the original proposal, please see our March 2011 Client Alert available at http://www.chapman.com/media/publication/108_media.971.pdf. The FINRA Regulatory Notice proposing the revised rules is available at http://www.finra.org/Industry/Regulation/Notices/2013/P197797 FINRA is accepting comments on the proposal until April 1, 2013.

Background

FINRA received 25 comment letters in response to its earlier proposal which would have created new FINRA Rules 2121 (Fair Prices and Markups, Markdowns and Commissions), 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities) and 2123 (Charges and Fees for Services Performed). The proposed rules would have generally incorporated existing NASD rules subject to significant changes. In consideration of some of the comments received, FINRA is now seeking comments on a revised proposal. The significant differences between the initial and new proposals are:

- The revised proposal amends proposed FINRA Rule 2121 to:
    - retain the "5% policy" (discussed below) and related concepts from NASD IM-2440-1 (FINRA initially proposed to delete the 5% policy);
    - establish a rebuttable presumption that a markup, markdown or commission in excess of 5 percent is unfair and unreasonable;
    - modify the "relevant factors" (discussed below) that member firms should take into consideration in determining the fairness of a markup, markdown or commission; and
    - delete previously proposed FINRA Rule 2121(e), a requirement that member firms provide commission schedule(s) for equity securities transactions to retail customers.
- The revised proposal amends proposed FINRA Rule 2122 to update the criteria applicable to eligible qualified institutional buyers ("QIB") purchasing or selling non-investment grade debt securities, whose transactions are excluded under the markup rules. The amendments would incorporate the standards regarding institutional suitability in FINRA Rule 2111(Suitability), rather than NASD IM-2310-3.
- The revised proposal amends proposed FINRA Rule 2123 to provide additional examples of charges and fees that are subject to the rule and include natural persons advised by an investment adviser and other natural persons as "retail customers" for the purposes of the rule.
- Finally, the revised proposal includes an amendment to FINRA Rule 0150 (Application of Rules to

Exempted Securities Except Municipal Securities) that extends the proposed markup rules to transactions in government securities.

Proposed FINRA Rule 2121—Fair Prices and Markups, Markdowns and Commissions

Fair and Reasonable Markups, Markdowns and Commissions. Proposed FINRA Rule 2121 would generally incorporate the requirements of NASD Rule 2440 with only minor changes. The existing rule generally requires that securities be sold to or purchased from customers at fair and reasonable prices and be subject to fair and reasonable commissions where a firm is acting as an agent. Consistent with the original proposal, the new rule would require a firm that acts as principal in a securities transaction with a customer to buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances. The relevant facts and circumstances for a principal transaction would include market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that the member firm is entitled to remuneration. If a firm acts as agent for its customer in any securities transaction, the firm would not be permitted to charge more than a fair and reasonable commission, commission-equivalent fee, or service charge, taking into consideration all relevant facts and circumstances. The relevant facts and circumstances for an agency transaction would include market conditions, the expense of executing the order, and the value of any service the member firm may have rendered by reason of its experience in and knowledge of such security and the market for the security. Consistent with the initial proposal, the new rule would not apply to (a) the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price or (b) certain transactions in non-investment grade debt securities with a qualified institutional buyer (QIB). The revised proposal would incorporate rule changes to extend the new markup rules to transactions in most government securities.

Retaining the 5% Policy. One of the most significant parts of the original FINRA proposal was that FINRA proposed to eliminate what has become known as the “5% Policy”. The 5% Policy is a general position taken by the FINRA Board beginning in 1943 and is currently addressed in NASD IM-2440-1. The current interpretive material provides that the question of whether markups or spreads are fair is one for which no definitive answer can be given and no interpretation can be all-inclusive because of different circumstances. However, the 5% Policy generally holds that in most transactions executed for customers, markups of 5 percent or less would be within the “fair and reasonable” standard of NASD Rule 2440. The “5% Policy” is a guide and not a rule, and that a markup pattern of 5 percent or even less might in certain circumstances be considered unfair or unreasonable.

FINRA proposed to eliminate the 5% Policy in the new rule based on the belief that the policy established a presumption that markups, markdowns and commissions in excess of 5 percent were prohibited or subject to additional scrutiny, requiring a firm to provide more justification to prove that such remuneration is not “excessive”. Due to significant opposition from commenters, FINRA now proposes to retain the 5% Policy concept within new FINRA Rule 2121. The new rule would provide, however, that when a member firm charges an amount in excess of 5 percent, a rebuttable presumption exists that it is unfair and unreasonable. While a member firm could overcome the presumption by demonstrating that the markup, markdown or commission is fair and reasonable based on the relevant factors set forth in the proposal, the presumption would not be rebutted solely based on disclosure to a customer of the firm’s markup, markdown or commission. In addition, FINRA specifically notes that firms should not view the new provision as establishing a specific ceiling or cap below which most markups, markdowns or commissions will not be viewed as excessive or will not be questioned by FINRA.

Relevant Factors in “Fair and Reasonable” Determination. Similar to the current rule, the new rule would set forth a non-exclusive list of seven factors that a member firm should consider in determining whether a markup, markdown or commission is fair and reasonable. FINRA now proposes substantive changes to three of the factors:

- Availability of the Security—The effort and cost of buying or selling a security would be permitted as factors if the security is “difficult to locate or source, is inactive or infrequently traded, is subject to market liquidity restraints relative to the size of the transaction sought to be executed, or if there are any unusual circumstances connected with its acquisition or sale”. The original proposal was limited to an “inactive security” only.

- Transaction Size—The revised proposal provides that a transaction involving a large amount of money may warrant a lower percentage of markup, markdown or commission where the expenses of handling the transaction do not rise by virtue of the size of the transaction. The original proposal merely provided that a smaller transaction could warrant a higher amount.

- Disclosure—The original proposal provided that disclosure of the amount of markup, markdown or commission to a customer before a transaction could be considered in determining whether a firm deals fairly with the customer. The revised proposal clarifies that the amount disclosed must be the total dollar amount *and* the percentage of the amount of the markup, markdown or commission.

Elimination of the "Proceeds Provision". Under the "proceeds provision" of NASD IM-2440-1(c)(5), when a customer sells one security and buys a second security at the same time using the proceeds of the sale, both trades are required to be treated as a single transaction for markup, markdown or commission purposes. This means that the total remuneration for both transactions would generally not be allowed to exceed the remuneration amount for a single transaction. FINRA proposed to eliminate this provision in its original proposal. While the proposal garnered significant comments, FINRA continues to believe that the provision should not be included in the new rule but that the concerns underlying the "proceeds provision" should be addressed through continued monitoring of accounts for churning and other fraudulent trading.

Proposed Commission Schedules Deleted. The original proposal would have required member firms to establish and make available to retail customers schedules of standard commission charges for equity securities transactions. In light significant objections of commenters, FINRA has deleted this proposed requirement.

Proposed FINRA Rule 2122—Markups and Markdowns for Debt Securities Transactions

In FINRA's original proposal, proposed FINRA Rule 2122 essentially mirrored current NASD IM-2440-2 related to transactions in debt securities other than municipal securities. The rule would generally contain: (a) the standards for determining a markup or a markdown in a transaction with a customer in a debt security other than a municipal security; (b) the procedures to identify prevailing market price; (c) the role of the dealer's contemporaneous cost in determining prevailing market price; (d) the characteristics of "similar securities"; (e) the role of similar securities in determining a markup or a markdown; and (f) an exemption for certain transactions in non-investment grade securities effected with certain QIBs. The new proposal incorporates various clarifying language primarily directed at provisions that apply when a dealer looks to alternative measures to determine the prevailing market price of a security. The new language also changes the exemption for transactions in non-investment grade securities effected with certain QIBs to match suitability obligations to institutional investors under the current suitability rule.

Proposed FINRA Rule 2123—Charges/Fees for Services

Consistent with the initial proposal, proposed FINRA Rule 2123 would restate the current NASD Rule 2430 requirement that charges and fees for services must be reasonable and not unfairly discriminate among customers. The rule would apply to all charges and fees for services not related to the execution of a transaction. Firms would be required to establish and make available to retail customers their schedules of standard charges and fees and disclosure similar to those described above. The revised proposal adds examples of charges and fees for miscellaneous services that would be subject to the rule. The revised proposal would also modify the originally-proposed definition of a "retail customer". Under the modified definition, a retail customer would mean a customer that does not qualify as an "institutional account" as defined in FINRA Rule 4512(c), except any natural person or any natural person advised by a registered investment adviser.

Submitting Comments

You may submit comments on the proposed rules by submitting a hard copy or by sending an e-mail to pubcom@finra.org. You may submit comments on the proposed rules until April 1, 2013.

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