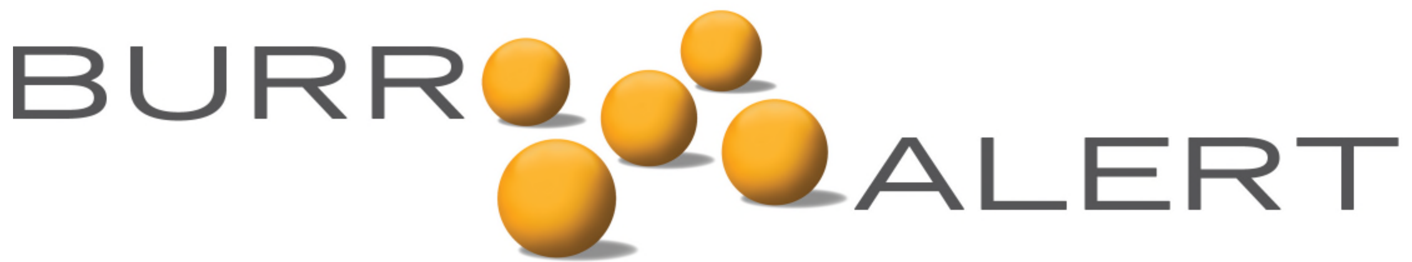

Proposed FINRA Rules Governing Markups, Commissions and Fees

Through its recent Regulatory Notice 13-07, the Financial Industry Regulatory Authority ("FINRA") announced and sought comments on its proposed amendments to rules governing markups, markdowns, commissions and fees associated with brokered investment transactions. This was the second solicitation for comments sought by FINRA for these rules, the first announced in Regulatory Notice 11-08. FINRA received 25 comment letters in response to Regulatory Notice 11-08 and subsequently sought comment on the additional revisions made in light of these letters.

FINRA's proposed amendments dealt with the "markup rules": (1) FINRA Rule 2121 on Fair Prices and Markups, Markdowns and Commissions, (2) FINRA Rule 2122 on Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities, and (3) FINRA Rule 2123 on Charges and Fees for Services Performed. Initially, in Regulatory Notice 11-08, FINRA proposed significant and substantive changes to the policies governing markups, markdowns and the information provided customers regarding commissions. But based on commenters' overwhelmingly negative feedback on these amendments, FINRA revised its proposals to make fewer dramatic changes.

While FINRA proposed the most amendments to FINRA Rule 2121 governing markups and commissions, the alterations were not substantial and instead addressed minor tweaks to the policies already in place. First, FINRA proposed retention of its well established policy of treating a 5% markup or markdown on brokered transactions as reasonable. Indeed, it is difficult to establish a conclusive markup or markdown amount, because what is fair under the circumstances for one transaction might not be for another. In an attempt to address this problem, FINRA sought in its initial proposals to entirely eliminate the 5% reasonableness standard and replace it with a qualitative test. But an overwhelming number of comments responding to the initial proposals opposed deleting the 5% policy, asserting that the system had been an effective regulatory tool for over 70 years and that replacing it with a subjective, qualitative system would confuse and complicate the calculations for markups and markdowns. Additionally, a definitive percentage for computing markups and markdowns allows member firms to establish more effective and efficient supervisory and compliance procedures. The comments proved persuasive and FINRA's new proposals suggested retaining the 5% policy. FINRA, however, also included a provision advising that the policy should be treated as a guide, and not a definitive rule. To further solidify and strengthen the 5% policy, FINRA proposed a rebuttable presumption that any markup or commission exceeding 5% is "unfair and unreasonable." It should be noted, however, that technology and market forces typically work to drive transaction costs down and the average

markup or markdown is substantially less than 5%. Thus, while FINRA obliged commenters by retaining the 5% policy, the effect of that concession may be minimal.

Second, FINRA proposed modifying FINRA Rule 2121(c) listing the "relevant factors" considered when determining whether a particular markup, markdown, or commission is fair by further specifying the purpose and scope of these factors, and, in some instances, broadening the scope of the factors so that more commissions fall into the gambit of what is considered fair. Specifically, FINRA proposed incorporating a non-exclusive list of seven factors from NASD IM-2440 for determining fairness. FINRA's explanation of the factors broadened and expanded upon these factors to provide most guidance to investors. For example, instead of borrowing NASD IM-2440's language that a transaction involving a small amount of money may warrant a higher percentage commission, FINRA expounded upon the provision by also stating that transactions involving a large amount of money may warrant a smaller percentage commission. This additional guidance is intended to simplify transactions and prevent disputes in the future.

Furthermore, FINRA backed away from its previous proposal of amending Rule 2121 to require member firms to provide their retail customers with commission schedules for all equity securities. FINRA deleted the requirement because of negative feedback received on the proposal in comment letters. Specifically, commenters believed the requirement was duplicative and unduly burdensome upon firms and their associated persons because similar information is already provided to customers.

With regard to FINRA Rule 2122 pertaining to markups and markdowns for transactions involving debt securities, FINRA recommended amending the criteria for when a qualified institutional buyer (QIB) is able to independently evaluate market risk and thus not be subject to the requirements governing markups and markdowns for the transaction. FINRA suggested in its proposal that this determination should be based on the standards for institutional suitability. This would require that a dealer have a reasonable and informed basis for believing that the QIB is capable of determining and evaluating the risk involved with dealing in non-investment grade debt securities, and the QIB must also affirmatively articulate that it is transacting in debt securities subject to its own judgment and decision. The proposals only slightly amend the Rule for when a QIB is not subject to markup requirements, and will likely have minimal impact.

Finally, for FINRA Rule 2123 relating to charges and fees for services performed by firms and associated persons, FINRA merely recommended including additional examples illustrating how to determine and calculate appropriate fees and expanding the definition of "retail customer" to include natural persons within the Rules' parameters. These amendments are unlikely to have a discernible impact on the Rules' application.

FINRA received several comment letters in response to the proposed amendments discussed above. While the letters at least touched upon all three proposals, commenters' most fervent discussion focused on FINRA's decision to retain the 5% threshold for determining the fairness of markups and

markdowns on brokered transactions. The amendment was raised in six comment letters received by FINRA. Four of the letters commended FINRA's decision to retain 5% as the threshold for determining fairness, basing their support primarily upon the policy's past success and objective application. Two of the comment letters disapproved of the policy and recommended that the threshold be lowered from 5% to closer to 2% or 3%. Specifically, Public Investors Arbitration Bar Association ("PIABA") supported lowering the percentage, asserting that based on a recent Harvard study, the average mark-up is only about 1.6% and the average mark-down is approximately 1.2%. Based on these calculations, PIABA claimed that the 5% policy is unreasonably high, ineffective, and inapplicable to most transactions. While some of PIABA's calculations are persuasive, the weight of industry support favors retention of the policy indicates that it is unlikely that FINRA will modify the Rule again prior to enactment. Furthermore, amendments to Rule 2122 or Rule 2123 likely did not receive enough attention to warrant FINRA readdressing its proposed amendments, and the Rules are likely to be enacted as currently drafted.

For more information, contact:

Ben Coulter at 205-458-5420 / bcoulter@burr.com or **Mignon Lunsford** at 205-458-5477 / mlunsford@burr.com, members of Burr & Forman LLP's General Commercial Litigation Group or your Burr & Forman attorney with whom you regularly work.

No representation is made that the quality of legal services to be performed is greater than the quality of legal services performed by other lawyers.