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Broker-Dealer Alert

SEC Approves Bond Mark-Up Disclosure Rules

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On November 17, 2016, the Securities and Exchange Commission (SEC or Commission) approved new rules requiring dealers to disclose on retail customer confirmations their mark-ups and mark-downs on most municipal and corporate bond transactions, calculated from the bond's prevailing market price (PMP).[1] The controversial new requirements—first considered by the SEC more than 40 years ago[2]—will have major implications for dealers in the fixed income markets.

Summary

By May 2018, broker-dealers for the entire range of debt securities must design and implement new policies, procedures and systems for disclosing their mark-ups and mark-downs on offsetting retail customer transactions, calculated from the bond's PMP. To determine PMP, firms must conduct a "waterfall" analysis as set forth in existing Financial Industry Regulatory Authority (FINRA) rules and adopted by the Municipal Securities Rulemaking Board (MSRB) as part of this rulemaking.

In developing their disclosure systems, firms must decide whether to (a) employ various manual techniques to perform the waterfall analysis on each retail trade, or (b) create, test and implement an automated system that fully and accurately captures the demands of the waterfall. The 18-month implementation period is an aggressive schedule in light of the work required.

Background

Following multiple rounds of rule proposals over the past two years, FINRA and the MSRB filed parallel rule amendments with the Commission in September 2016.[3]

Specifically, FINRA proposed to amend FINRA Rule 2232 and the MSRB proposed to amend MSRB Rule G-15 to require dealers to disclose on retail customer confirmations the amount of

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[1] Exchange Act Release No. 79346 (Nov. 17, 2016), 81 Fed. Reg. 84659 (Nov. 23, 2016) (SR-FINRA-2016-032) (FINRA Approval Order); Exchange Act Release No. 79347 (Nov. 17, 2016), 81 Fed. Reg. 84637 (Nov. 23, 2016) (SR-MSRB-2016-12) (MSRB Approval Order).

[2] *See* Securities Confirmations, Exchange Act Release No. 12806, 41 Fed. Reg. 41432 (Sept. 22, 1976).

[3] Exchange Act Release No. 78573 (Aug. 15, 2016), 81 Fed. Reg. 55500 (Aug. 19, 2016) (SR-FINRA-2016-032) (FINRA Proposed Rule Change); Exchange Act Release No. 78777 (Sept. 7, 2016), 81 Fed. Reg. 62947 (Sept. 13, 2016) (SR-MSRB-2016-12) (MSRB Proposed Rule Change).

any mark-up/mark-down, calculated from the PMP, for certain transactions in fixed income securities. Additionally, the MSRB proposed to amend MSRB Rule G-30 to provide guidance on the calculation of PMP that is generally harmonized with the existing guidance contained in FINRA Rule 2121.02.

The Commission approved both proposals on November 17, 2016. The effective date of the proposed rules, which has yet to be announced, will be no later than 18 months following Commission approval.

Overview of the Disclosure Requirement

Scope. Subject to certain exceptions, FINRA Rule 2232 and MSRB Rule G-15 will require disclosure of a dealer's mark-up/mark-down if the dealer:

- effects a transaction on a principal basis in a corporate or agency debt security (under the FINRA rule) or in a municipal security (under the MSRB rule) with a retail customer;[4] and

- engages in one or more offsetting principal transaction(s), in an aggregate trading size that meets or exceeds the size of the retail customer trade, on the same trading day as the retail customer.

If the offsetting transaction occurs with an affiliate and is not an arms-length transaction, the dealer must "look through" to the time and terms of the affiliate's transaction with a third party to determine whether the disclosure requirement is triggered.

"Offsetting" Transactions. As stated in the new rules, there must be "offsetting" customer and principal trades in order to trigger the mark-up disclosure requirement. To illustrate this concept, both FINRA and the MSRB provided the following example:

> [I]f a member (dealer) purchased 100 bonds at 9:30 AM, and then satisfied three customer orders for 50 bonds each in the same security on the same day without purchasing any more of the bonds, the proposal would require mark-up disclosure on two of the three trades, since one of the trades would have been satisfied by selling out of the member's (dealer's) inventory rather than through an offsetting principal transaction by the member (dealer).[5]

Exceptions. The mark-up disclosure requirement will not be triggered by an offsetting same-day principal trade executed by a trading desk that is "functionally separate" from the dealer's trading desk that executed the retail transaction. To qualify for this exception, the dealer must have in place policies and procedures reasonably designed to ensure that the "functionally separate" trading desk had no knowledge of the customer transaction.

In addition, the FINRA disclosure requirement will not apply if the member acquired the security in a fixed-price offering and sold the security to retail customers at the fixed-price offering price

[4] Both the FINRA and the MSRB rules apply to transactions with "non-institutional" customers—*i.e.*, a customer account that is not an institutional account, as defined in FINRA Rule 4512(c) or MSRB Rule G-8(a)(xi).

[5] FINRA Approval Order at 18; MSRB Approval Order at 29.

on the day the securities were acquired,[6] and the MSRB's disclosure requirement will not apply to list-offering price transactions or transactions in municipal fund securities.[7]

Calculation of the Mark-up/Mark-down. As described in more detail below, FINRA Rule 2232 and MSRB Rule G-15 will require dealers to calculate their mark-up/mark-down in accordance with the PMP guidance contained in FINRA Rule 2121 and MSRB Rule G-30, respectively.

Presentation on Confirmations. The mark-up/mark-down disclosure must be expressed both as a total dollar amount (*i.e.*, the dollar difference between the customer's price and the security's PMP) and as a percentage amount (*i.e.*, the mark-up's percentage of the security's PMP).

Firms will be permitted to include on confirmations explanatory language or disclosures regarding how the disclosure was derived; however, labeling the required mark-up/mark-down disclosure itself as an "estimate" or "approximate" figure is prohibited.[8] In this regard, dealers will have the flexibility to craft their own language "that explains PMP as a concept, or that details the . . . methodology for determining PMP, or notes the availability of information about methodology upon request," provided such statements are accurate and not misleading.[9] FINRA suggested that it will evaluate the potential need to provide standardized or sample disclosures that would be appropriate under the rule.[10]

Link to TRACE/EMMA and Time of Execution. Irrespective of whether mark-up/mark-down disclosure is required for a particular transaction, both FINRA and the MSRB will require that dealers provide on all trade confirmations:

- a reference, and security-specific hyperlink if the confirmation is electronic, to a webpage hosted by FINRA or the MSRB that contains publicly available trading data for the specific security from FINRA's Trade Reporting and Compliance Engine (TRACE) or the MSRB's Electronic Municipal Market Access (EMMA) system, along with a brief description of the type of information available on that page; and

- the execution time of the customer transaction.

The FINRA rule requires the time of execution to be expressed *to the second*.[11] The MSRB rule does not set forth such a specific requirement; however, the Commission's approval order states that the time of execution must be expressed *to the minute*.[12]

MSRB Rule G-30—PMP Guidance

To support its mark-up disclosure requirement, the MSRB is adding new supplementary material to Rule G-30 to provide guidance on determining PMP. The MSRB's new guidance is substantially similar to the "waterfall" of factors for determining PMP provided in FINRA Rule 2121.02.

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[6] *See* proposed FINRA Rule 2232(d)(2).

[7] *See* proposed MSRB Rule G-15(a)(i)(F)(2).

[8] FINRA Approval Order at 47-48; MSRB Approval Order at 51-52.

[9] FINRA Approval Order at 48; MSRB Approval Order at 51-52.

[10] FINRA Approval Order at 30.

[11] *See* proposed FINRA Rule 2232(e); FINRA Approval Order at 8.

[12] MSRB Approval Order at 16.

In general, under MSRB Rule G-30, Supplementary Material .06, PMP is presumptively determined by referring to the dealer's contemporaneous cost (or proceeds). This presumption may be overcome by showing that interest rates have changed "to a degree that such change would reasonably cause a change in municipal securities pricing," the credit quality of the security has "changed significantly," or news was issued that "had an effect on the perceived value of the municipal security."[13] If the dealer's cost is (or proceeds are) not contemporaneous, or if the presumption is overcome, a dealer must consider, in order (1) a hierarchy of pricing factors, including contemporaneous inter-dealer transaction prices; (2) prices or yields from contemporaneous inter-dealer or institutional transactions and quotations in "similar" securities; and (3) economic models.

Notably, although the MSRB's PMP guidance originated for the purpose of the mark-up disclosure requirement, it is being adopted as an overarching fair pricing methodology under Rule G-30 and will apply to transactions with institutional as well as retail customers.

Determination of PMP for the Purpose of Mark-Up Disclosure

Automation. In response to the proposed rule amendments, commenters raised concerns that PMP determinations will need to be automated at the time of trade. These commenters argued that it is not practicable to automate the subjective "waterfall" methodology and requested the flexibility to adopt alternative, automated methodologies to estimate PMP.

The Commission, FINRA and the MSRB rejected this premise. The Commission stated its belief that "it is feasible to automate the determination of PMP in accordance with the [PMP guidance] to the extent a dealer chooses to do so."[14] The Commission further stated that "a dealer's election to use automated processes to support pricing of retail trades, and thus determine the PMP, would not justify departure from" the requirement to price securities in accordance with the applicable PMP guidance.[15]

Accordingly, under the new rules, dealers will be required to adopt reasonable policies and procedures to determine PMP, and such policies and procedures must be designed to implement fully the guidance in FINRA Rule 2121 and MSRB Rule G-30. Alternative methods of estimating PMP for disclosure purposes will be prohibited.

Reasonable Policies and Procedures. Both FINRA and the MSRB acknowledged that the determination of PMP for a particular security "may not be identical" across dealers.[16] Firms may rely on "reasonable policies and procedures" to determine PMP in a manner consistent with FINRA Rule 2121 and MSRB Rule G-30, applied consistently across customers.[17]

In this regard, FINRA stated that members could "make reasonable judgments about how they apply FINRA Rule 2121," and that "there are ways for members to represent subjective judgments with objective logic that could be documented and applied consistently through reasonable policies and procedures."[18] For example, "certain judgments could be documented up front with the requisite assumptions explained in a member's procedures," such as whether a

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[13] *See* proposed MSRB Rule G-30, Supplementary Material .06.

[14] MSRB Approval Order at 49.

[15] MSRB Approval Order at 49.

[16] FINRA Approval Order at 29; MSRB Approval Order at 15.

[17] FINRA Approval Order at 29-30; MSRB Approval Order at 15.

[18] FINRA Approval Order at 24-25.

transaction is "contemporaneous," whether securities are similar, and what economic models provide about the price of an illiquid security.[19]

Similarly, the MSRB stated its expectation that such policies and procedures "will be reasonably designed to implement all applicable components of the PMP determination."[20] Accordingly, "it may be reasonable for a dealer that chooses largely to automate the [PMP] determination to establish in its policies and procedures objective criteria reasonably designed to implement aspects of the waterfall that are not prescribed and as to which dealers would have discretion to exercise a degree of subjectivity if the determination were not automated."[21] For example, in determining its contemporaneous cost in connection with a sale to a customer, a dealer's policies and procedures could consistently apply a "last in, last out" approach.[22] With respect to determining whether securities are similar, "the security must be at least highly similar to the subject security with respect to nearly all of the listed similar security factors that are relevant to the subject security at issue."[23]

Adjustments to Contemporaneous Cost. According to both FINRA and the MSRB, where a dealer's contemporaneous cost is derived from a retail customer transaction, the dealer may establish a methodology to adjust contemporaneous cost to account for any mark-up or mark-down charged in the retail customer transaction.[24] Nevertheless, FINRA stated that additional adjustments to contemporaneous cost determinations, such as adjustments to reflect the size or side of a contemporaneous trade, would be inconsistent with Rule 2121.[25]

Intra-Day Confirmations. Under FINRA and MSRB guidance, dealers will not be expected to cancel and resend a confirmation to revise the mark-up or mark-down disclosure "solely based on the occurrence of a subsequent transaction or event that would otherwise be relevant to" the PMP calculation.[26] Accordingly, dealers may determine PMP, as a final matter for disclosure purposes, based on the information available "at the time the member inputs the PMP and associated mark-up information into its systems to generate a confirmation."[27]

Third-Party Pricing Services. Both FINRA and the MSRB stated that dealers will not be prohibited from using third-party pricing services to document and perform the steps of the FINRA Rule 2121 or MSRB Rule G-30 analysis.[28] Nevertheless, dealers that elect to use such pricing services will retain the ultimate compliance responsibility and must conduct the due diligence necessary to ensure that the third-party service providers produce calculations consistent with the PMP guidance.[29]

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[19] FINRA Approval Order at 25.

[20] MSRB Approval Order at 33.

[21] Letter from Michael L. Post, General Counsel—Regulatory Affairs, MSRB, to Brent J. Fields, Secretary, Commission, dated November 14, 2016, 11 (MSRB Response Letter).

[22] MSRB Response Letter at 12.

[23] MSRB Response Letter at 13.

[24] FINRA Approval Order at 24; MSRB Approval Order at 19.

[25] Letter from Alexander Ellenberg, Associate General Counsel, FINRA, to Brent J. Fields, Secretary, Commission, dated November 14, 2016, 8 (FINRA Response Letter).

[26] FINRA Approval Order at 28; MSRB Approval Order at 48.

[27] FINRA Approval Order at 28.

[28] FINRA Approval Order at 26; MSRB Approval Order at 32.

[29] FINRA Approval Order at 26; MSRB Approval Order at 32.

Conclusion

FINRA and the MSRB will announce when the new rules will take effect in an upcoming regulatory notice. Consistent with the rule proposals, the effective date will be no later than 18 months following Commission approval. Recognizing that dealers may have additional, specific implementation questions, FINRA stated that it will work closely with the industry and the MSRB to issue further guidance as necessary.[30]

[30] FINRA Approval Order at 26.

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