



OFFICE OF THE
INVESTOR ADVOCATE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

*** MEMORANDUM ***

TO: U.S. Securities and Exchange Commission

FROM: Rick A. Fleming, Investor Advocate¹

DATE: November 7, 2016

RE: Recommendation of the Investor Advocate
File Nos. SR-FINRA-2016-032; SR-MSRB-2016-12

RECOMMENDATION:

Approve the proposals from the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board to require disclosure of mark-ups and mark-downs from prevailing market price on retail customer confirmations relating to certain transactions in fixed income securities and municipal securities.

I. Introduction

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 (“Exchange Act”),² the Office of the Investor Advocate is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations (“SROs”). As appropriate, we make recommendations to help ensure that the interests of investors are fully considered as those rules are adopted. In furtherance of this objective, we submit this recommendation to the Commission regarding two related rule proposals from the Financial

¹ This Recommendation expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for all analyses, findings, and conclusions contained herein.

² 15 U.S.C. § 78d(g)(4).

Industry Regulatory Authority, Inc. (“FINRA”) and Municipal Securities Rulemaking Board (“MSRB”): File No. SR-FINRA-2016-032, Notice of Filing of a Proposed Rule Change Relating to FINRA Rule 2232 (Customer Confirmations) to Require Members to Disclose Additional Pricing Information on Retail Customer Confirmations Relating to Transactions in Fixed Income Securities (“FINRA Notice”);³ and File No. SR-MSRB-2016-012, Notice of Filing of a Proposed Rule Change to MSRB Rules G-15 and G-30 to Require Disclosure of Mark-Ups and Mark-Downs to Retail Customers in Certain Principal Transactions and to Provide Guidance on Prevailing Market Price (“MSRB Notice”).⁴

We support these proposed rule changes and recommend that the Commission approve both proposals.⁵ We believe these enhancements to pricing disclosure in the fixed income markets are long overdue and will greatly benefit retail investors. By requiring firms to disclose the mark-ups on customer confirmations, retail investors will be better equipped to evaluate transactions and the quality of service provided to them by a firm. This information should also have a preventative effect because regulators as well as retail investors will be able to detect improper practices more easily, and firms will be less likely to charge excessive mark-ups when the price differential must be disclosed so clearly.

³ Proposed Rule, Notice of Filing of a Proposed Rule Change Relating to FINRA Rule 2232 (Customer Confirmations) to Require Members to Disclose Additional Pricing Information on Retail Customer Confirmations Relating to Transactions in Fixed Income Securities, Securities Exchange Act Release No. 78573 [Aug. 15, 2016], 81 Fed. Reg. 55500 [Aug. 19, 2016], File No. SR-FINRA-2016-032, <https://www.gpo.gov/fdsys/pkg/FR-2016-08-19/pdf/2016-19773.pdf> [hereinafter, FINRA Notice].

⁴ Proposed Rule, Notice of Filing of a Proposed Rule Change to MSRB Rules G-15 and G-30 to Require Disclosure of Mark-Ups and Mark-Downs to Retail Customers in Certain Principal Transactions and to Provide Guidance on Prevailing Market Price, Securities Exchange Act Release No. 78777 [Sept. 7, 2016], 81 Fed. Reg. 62947 [Sept. 13, 2016], File No. SR-MSRB-2016-12, <https://www.gpo.gov/fdsys/pkg/FR-2016-09-13/pdf/2016-21909.pdf> [hereinafter, MSRB Notice].

⁵ Our recommendation is based upon the Notices as originally published for public comment. FINRA, MSRB, or Commission staff may be able to identify and suggest additional enhancements to the proposed rules, and we may support such modifications.

II. Previous Proposals

For several years, FINRA and the MSRB have explored ways to increase the transparency of pricing for retail investors who engage in the purchase or sale of fixed income securities. The current proposals follow previous requests for comment by FINRA and the MSRB.

On November 14, 2014, FINRA and the MSRB released for comment two related proposals in FINRA Regulatory Notice 14-52 and MSRB Regulatory Notice 2014-20.⁶ The MSRB proposed requiring dealers to disclose on customer confirmations the “price to the dealer in a ‘reference transaction’ and the differential between the price to the customer and the price to the dealer for same-day, retail-size principal transactions.”⁷ Similarly, FINRA proposed requiring disclosure “where a firm executes a sell (buy) transaction of ‘qualifying size’ with a customer and executes a buy (sell) transaction as principal with one or multiple parties in the same security within the same trading day, where the size of the customer transaction(s) would otherwise be satisfied by the size of one or more same-day principal transaction(s).”⁸

The Office of the Investor Advocate supported these changes. We submitted comment letters to encourage FINRA and the MSRB to adopt their proposed amendments because we

⁶ MSRB, Regulatory Notice 2014-20, Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations, at 1 (Nov. 17, 2014), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2014-20.ashx?n=1> [hereinafter MSRB Notice 2014-20]; FINRA, Regulatory Notice 14-52, Pricing Disclosure in the Fixed Income Markets, at 3 (Nov. 17, 2014), http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf. [hereinafter FINRA Notice 14-52].

⁷ MSRB Notice 2014-20, *supra* note 6, at 1.

⁸ FINRA Notice 14-52, *supra* note 6, at 3.

believed that retail investors would benefit from the inclusion of the additional pricing information on their customer confirmations.⁹

After consideration of all the comments received, FINRA and the MSRB made significant revisions to their initial proposals and released for comment two revised proposals.¹⁰ These revised proposals diverged from one another in some important respects.

On September 24, 2015, the MSRB issued Regulatory Notice 2015-16 for comment. The new proposal changed the methodology for calculating the pricing information that was to be disclosed on the customer confirmation. Instead of using the price to the dealer in a “reference transaction” to determine the cost that would be disclosed to the retail investor, the MSRB proposed to require disclosure of a mark-up that was the difference between the price for the customer and the “prevailing market price” (“PMP”) of the bond at the time of the purchase or sale.¹¹ Moreover, instead of requiring disclosure of the mark-up whenever the dealer engaged in its own same-side transaction within the same trading day as the customer transaction, the MSRB proposed to shorten the relevant window of time to two hours.¹²

⁹ See Comment Letter, Rick A. Fleming, Investor Advocate, SEC, *RE: MSRB Notice 2014-20* (Jan. 20, 2015), <http://www.msrb.org/RFC/2014-20/USSEC.pdf>; Comment Letter, Rick A. Fleming, Investor Advocate, SEC, *RE: FINRA Notice 14-52* (Jan. 20, 2015), http://www.finra.org/sites/default/files/notice_comment_file_ref/SEC.pdf.

¹⁰ See MSRB, Regulatory Notice 2015-16, Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers (Sep. 24, 2015), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-16.ashx?la=en> [hereinafter MSRB Notice 2015-16]; see also FINRA, Regulatory Notice 15-36, Pricing Disclosure in the Fixed Income Markets (Oct. 12, 2015), <http://www.finra.org/industry/all-requests-for-comments> [hereinafter FINRA Notice 15-36].

¹¹ MSRB Notice 2015-16, *supra* note 10, at 7.

¹² MSRB Notice 2015-16, *supra* note 10.

On October 12, 2015, FINRA issued Regulatory Notice 15-36 for comment. It made certain changes from the original FINRA proposal,¹³ but it retained the same basic approach. It proposed to require pricing disclosure that is based upon a reference transaction, and it retained the full trading day as a threshold for disclosure.¹⁴

The Office of the Investor Advocate supported aspects of both FINRA Notice 15-36 and MSRB Notice 2015-16.¹⁵ In particular, we strongly supported FINRA's same trading day timeframe, but we expressed a preference for the MSRB's proposed use of PMP to calculate the mark-up. We also encouraged both FINRA and the MSRB to adopt consistent rules so that investors would not be confused by different pricing disclosures in different parts of the fixed income markets.

On February 18, 2016, the MSRB issued MSRB Regulatory Notice 2016-07, in which it sought public comment on proposed guidance for determining the PMP for purposes of mark-up disclosure.¹⁶ The Office of the Investor Advocate filed a comment letter expressing significant concern with how the PMP may be determined under the current guidance in circumstances

¹³ FINRA Notice 15-36 differs from FINRA Notice 14-52 in that it reclassifies the types of trades that would trigger the disclosure requirement; allows for alternative calculation methods for more complex trade scenarios; allows firms to choose whether or not to disclose the reference price, or disclose the reference price with clarifying information for situations in which there is a material change to the price of a security; and requires firms to include TRACE data on the customer confirmation. *See* FINRA Notice 15-36, *supra* note 10; FINRA Notice 14-52, *supra* note 6.

¹⁴ Specifically, a firm would be required to disclose on the customer confirmation the price to the customer, the price to the firm of the same-day trade (reference price), and the differential between the two if "a firm sells to a customer as principal and on the same day buys the same security as principal from another party." *See* FINRA Notice 15-36 at 2.

¹⁵ *See* Comment Letter, Rick A. Fleming, Investor Advocate, SEC, *RE: MSRB Notice 2015-16, RE: FINRA Notice 15-36* (Dec. 11, 2015), <https://www.sec.gov/about/offices/investorad/comment-letter-msrb-finra-investor-advocate-121115.pdf>.

¹⁶ MSRB, Regulatory Notice 2016-07, Request for Comment on Draft Amendments to MSRB Rule G-30 to Provide Guidance on Prevailing Market Price (Feb. 18, 2016), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2016-07.ashx?n=1> [hereinafter MSRB Notice 2016-07].

involving non-arm's length affiliate transactions.¹⁷ We noted that the MSRB's proposed guidance largely followed the existing FINRA guidance for calculating PMP of other fixed income securities, and we proposed potential solutions for consideration by FINRA and the MSRB prior to filing proposed rule changes with the Commission.¹⁸

III. Analysis of Current Proposals

As described above, the Office of the Investor Advocate has previously expressed views with respect to four key issues in the earlier proposals. We believe it is important for FINRA and the MSRB to be consistent in their approaches, we believe the appropriate window for disclosure is the full trading day, we prefer the use of PMP for calculating the mark-up, and, if PMP is used, we believe it is necessary to look through transactions with affiliates. Each of these issues has been resolved to our satisfaction in the current proposals.

1. Consistency of Approach

As an initial matter, we believe retail investors would be poorly served by pricing disclosures that are different for corporate bonds as compared to municipal bonds. To avoid retail investor confusion, it is important for FINRA and the MSRB to adopt consistent rules related to confirmation disclosure.

In their second round of proposals, FINRA and the MSRB diverged in their approaches to pricing disclosure. However, their current proposals provide a coordinated and consistent approach to mark-up disclosure in corporate and municipal bond transactions. We believe this deliberate approach will lead to consistent disclosures across the fixed income markets and will provide retail investors with better post-trade price transparency.

¹⁷ *Id.* at 2.

¹⁸ *See id.* at 2-8.

2. Window of Time for Disclosure

In the current proposals that are under consideration by the Commission, both FINRA and the MSRB require pricing disclosure whenever the dealer engages in its own same-side transaction within the same trading day as the customer transaction. We agree that the window of time for disclosure should be the full trading day, and we strongly opposed the earlier proposal by the MRSB to shift to a two-hour window.

Although dealers often trade within two hours under existing rules, dealers could easily adjust their behavior to avoid disclosure requirements that are less than a full day. Therefore, current trading behavior is not necessarily indicative of trading behavior that would occur if a time frame of less than one day was implemented. Moreover, disclosure avoidance is much more difficult if disclosures are required for transactions within the full trading day. A dealer takes on much greater balance sheet risk by holding inventory overnight, which would deter dealers from separating transactions in order to avoid disclosure.

3. Calculation of the Mark-up

As noted above, FINRA and the MSRB sought public comment on mark-up disclosure as well as reference pricing disclosure. The Office of the Investor Advocate initially supported reference price disclosure, finding it to be a significant improvement over the *status quo*. Such an approach also had the appeal of simplicity, meaning the associated disclosure would be relatively easy for dealers to calculate. However, the Office of the Investor Advocate believes there are advantages to a mark-up disclosure requirement that utilizes the PMP.

Admittedly, PMP-based disclosure may lead to disclosure of a smaller cost to retail investors under certain circumstances. For example, if a dealer purchases a security and there is

a significant positive market move prior to the resale to a retail investor, the amount of the mark-up would only be the difference between the price of the resale and the PMP at the time of the resale, instead of the full difference between the original purchase and the subsequent resale. However, the PMP-based approach provides retail investors with the relevant information about the actual compensation the retail investor is paying the dealer for the transaction. It reflects market conditions and has the potential to provide a more accurate benchmark for calculating transaction costs.

Importantly, we note that the calculation of a PMP-based mark-up, once established under these rules, need not be limited to a single trading day. After the systems are in place for disclosing mark-ups on same-day transactions, dealers may decide for competitive reasons to disclose mark-ups on all transactions. Moreover, FINRA and the MSRB could choose to require disclosure beyond the one-day window after assessing the implementation of the new rules. In contrast, because a reference price disclosure model does not account for intervening market events that could impact the value of the bond during the lag between the reference transaction and the customer transaction, the disclosure becomes less meaningful as the window for disclosure expands. Thus, for disclosure of pricing information beyond a one day window, a mark-up model would serve as a better framework than a reference price model.

Instead of a reference price model, the current proposals that are under consideration by the Commission would require dealers to use the PMP to calculate the mark-up for disclosure on customer confirmations.¹⁹ The Office of the Investor Advocate considers this the better

¹⁹ See FINRA Notice, *supra* note 3; see also MSRB Notice, *supra* note 4.

alternative. The Proposing Releases would also require dealers to express the mark-up both as a total dollar amount and as a percentage of PMP²⁰ — a level of disclosure that we support.

4. Looking Through Transactions with Affiliates

Although we support a move to disclosure of a mark-up that is based upon PMP, we are concerned with potential manipulation of the PMP calculation. Errors in the calculation, whether intentional or inadvertent, could significantly alter the information provided to retail investors. With this risk in mind, we have encouraged FINRA and the MSRB to monitor carefully the industry's implementation of the rules to ensure that dealers appropriately determine the PMP.

One area of particular concern is the potential for manipulating the PMP by utilizing transactions with affiliates. Specifically, the Office of the Investor Advocate was uncertain whether the MSRB's proposed PMP guidance would take into account the fact that, in non-arms-length transactions between affiliates, the contemporaneous price resulting from the transaction is more likely to reflect a mark-up instead of the true PMP. In our comment letter to the MSRB, we set forth the following example to illustrate our concern:

Assume that Dealer A1, a market-facing dealer, and Dealer A2, a retail customer-facing dealer, are affiliates owned by Company A. On the same trading day, the following three transactions occur:

- Dealer A1 purchases a bond from an unaffiliated third-party for \$90 (“Transaction 1”);
 - Dealer A1 then displays the bond for sale for \$93 on Dealer A2's customer-facing platform;
 - During the day, no other dealers display any price for the bond.
 - Retail Investor sees the bond listed for \$93 and places an order with Dealer A2 to purchase it at the displayed price;

²⁰ FINRA Notice, *supra* note 3, at 55502; MSRB Notice, *supra* note 4, at 62950.

- Dealer A2 purchases the bond from Dealer A1 at \$93 (“Transaction 2”); and
- Dealer A2 sells the bond to Retail Investor for \$93 + \$1 trading fee.²¹

In this scenario, Dealer A2 may determine that the PMP would be \$93—the contemporaneous cost to Dealer A2 as evidenced by Transaction 2 between affiliates. If so, any mark-up disclosure provided to a retail investor would indicate the retail investor paid only \$1 above the PMP. The Office of the Investor Advocate strongly believes that Transaction 1 should determine the PMP and that Dealer A2 should be required to look through Transaction 2, a non-arm’s length affiliate transaction, to determine the PMP. Under this approach, the PMP would be \$90 and the affiliate transaction would not mask the overall cost paid by the retail investor to the two affiliates of Company A.

In our comment letter, the Office of the Investor Advocate proposed three potential solutions to the MSRB to prevent a manipulation of PMP in transactions with affiliates. We believe the current proposal by the MSRB satisfies our concerns by making clear that a dealer must look through non-arms-length transactions with affiliates to calculate the PMP. Similarly, the proposed rule by FINRA would also “require members to apply the ‘look through’ where a member’s transaction with its affiliate was not at arms-length.”²² The proposed rules provide exceptions for functionally separate trading desks and fixed-price offerings.²³

5. Implementation

Both FINRA and the MSRB propose a one-year implementation period from the date of Commission approval. The Office of the Investor Advocate recognizes that technical and system

²¹ MSRB Notice 2016-07, *supra* note 16, at 4-5.

²² FINRA Notice, *supra* note 3, at 55501.

²³ FINRA Notice, *supra* note 3, at 55502.

changes are required for compliance with the proposed rules. We also note the concerns raised by commenters seeking a longer implementation period.

The Office of the Investor Advocate believes that a one-year implementation period is reasonable and urges the Commission to impose identical effective dates for both proposed rules. If necessary and appropriate, the Commission may later postpone the effective date of the proposed rules.

IV. Conclusion

The current proposals reflect many of the suggestions that the Office of the Investor Advocate submitted in several comment letters to FINRA and the MSRB as they developed their proposals to improve post-trade price transparency in fixed income markets. We believed then, as we do now, that retail investors will benefit greatly from the significant changes that are being proposed. Accordingly, we recommend that the Commission approve both the FINRA and MSRB proposals.