Regulatory Notice 14-52

November 2014

Pricing Disclosure in the Fixed Income Markets

FINRA Requests Comment on a Proposed Rule Requiring Confirmation Disclosure of Pricing Information in Fixed Income Securities Transactions

Comment Period Expires: January 20, 2015

Executive Summary

FINRA is requesting comment on a proposed FINRA rule that would require firms to disclose additional information on customer confirmations for transactions in fixed income securities. Specifically, FINRA is proposing that, for same-day, retail-size principal transactions, firms disclose on the customer confirmation the price to the customer, the price to the member of a transaction in the same security, and the differential between those two prices. FINRA and the Municipal Securities Rulemaking Board (MSRB) have discussed a coordinated approach to potential rulemaking in this area. The MSRB also is publishing a notice soliciting comment on a similar proposal.

The text of the proposed rules can be found in Attachment A.

Questions concerning this *Notice* should be directed to:

- Patrick Geraghty, Vice President, Market Regulation, at (240) 386-4973;
- Cynthia Friedlander, Director, Fixed Income Regulation, Regulatory Operations at (202) 728-8133; or
- Andrew Madar, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8056.

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management
- Trading

Key Topics
- Fixed Income Securities
- Pricing Information
- Transaction Confirmations

Referenced Rules & Notices
- FINRA Rule 2232
- SEA Rule 10b-10
- MSRB Regulatory Notice 2014-20

Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by January 20, 2015.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[2]

Background and Discussion

As part of its oversight of corporate and agency bond transactions, FINRA monitors firms' pricing of transactions based on TRACE reports. FINRA has observed that a significant number of retail-sized transactions (100 bonds or less or bonds with a face value of $100,000 or less) appear to have offsetting trades by the member firm in very close conjunction. Specifically, using data from the third quarter of 2013 for corporate bonds, FINRA has observed that over 60 percent of retail-size customer trades had corresponding principal trades on the same trading day. In over 88 percent of these events, the principal and the customer trades occurred within thirty minutes of each other. FINRA also has observed that while many of these trades have apparent mark-ups within a close range, significant outliers exist, indicating that customers in those trades paid considerably more than customers in other similar trades.[3] Although knowledgeable industrious customers could observe these trading patterns retrospectively using TRACE data, our understanding is that retail customers do not typically consult TRACE data.[4]

Customer confirmations already disclose the price to the customer of the bond transaction. FINRA believes that customers in retail-size trades would benefit from additional confirmation disclosure of the price of the offsetting trade by the firm and the differential between these prices when the offsetting trade is within the same trading day.

Recent Developments

In 2012, the Securities and Exchange Commission (SEC) issued a report on the municipal securities market, which surveyed the market structure and disclosure practices of the municipal securities market and made several recommendations including improving pre-trade and post-trade transparency and reinforcing existing dealer obligations.[5] Among other things, the report recommended that the MSRB require municipal bond dealers to disclose to customers on confirmations for riskless principal transactions the amount of any mark-up or mark-down.[6]

In addition, in a speech given on June 20, 2014, SEC Chair Mary Jo White broadly identified initiatives to address investor concerns in the fixed income markets.[7] Among other things, Chair White stated that the SEC would work with FINRA and the MSRB to develop rules regarding the disclosure of mark-ups in "riskless principal" transactions for both corporate and municipal bonds[8] to help customers assess the reasonableness of their dealer's compensation, as riskless principal transactions become more common in the fixed income markets.[9]

Proposed Disclosure Requirement

As described in more detail below, FINRA believes that enhancing the disclosure requirements for transactions in fixed income securities to include additional pricing information will benefit investors by providing them with more information to better evaluate their transactions. FINRA is therefore proposing to amend FINRA Rule 2232 to require customer confirmation disclosure of same-day pricing information for customer retail size transactions in corporate and agency debt securities.[10]

Specifically, 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), confirmation disclosure to the customer would be required. That disclosure would entail (i) the price to the customer; (ii) the price to the firm of the same-day trade; and (iii) the difference between those two prices.[11] The rule would define "qualifying size" as a purchase or sale transaction of 100 bonds or less or bonds with a face value of $100,000 or less, based on reported quantity, which is designed to capture those trades that are retail in nature.

The following examples address whether a transaction would trigger the proposed confirmation disclosure requirement:[12]

Example 1

- 10:00:00 AM Firm A purchases 50 XYZ bonds from a dealer at a price of 100 for $50,000.
- 10:00:15 AM Firm A sells 50 XYZ bonds to one customer at a price of 102 for $51,000.

Since the transaction involves the purchase of 50 bonds by the customer within the same trading day as Firm A's purchase of the same number of bonds, Firm A would be required to disclose on the customer confirmation the price to the firm (100), the price to the customer (102) and the differential between the two prices (2).

Example 2

- 10:00:00 AM Firm A purchases 500 XYZ bonds from a dealer at a price of 100 for $500,000.
- 10:15:00 AM Firm A sells 100 XYZ bonds to 5 customers at a price of 102.50 for $102,500 per customer.

Since the transactions involve the purchase of 100 bonds by each customer within the same trading day as Firm A's purchase of the same total number of bonds, Firm A would be required to disclose on the customer confirmations to each of the 5 customers the price to the firm (100), the price to the customer (102.50), and the differential between the two prices (2.50).

Example 3

- 10:00:00 AM Firm A purchases 500 XYZ bonds from a dealer at a price of 100 for $500,000.
- 10:15:00 AM Firm A sells 30 XYZ bonds to 1 customer at a price of 102.50 for $30,750.

Since the size of the customer transaction was satisfied by the size of the firm's principal transaction on the same day, Firm A would be required to disclose on the customer confirmation the price to the firm (100), the price to the customer (102.50), and the differential between the two prices (2.50).

Example 4

- 10:00:00 AM Firm A sells 100 XYZ bonds to a customer at a price of 102 for $102,000.
- 10:15:00 AM Firm A buys 500 XYZ bonds from a dealer at a price of 100 for $500,000.

Since the size of the customer's purchase of bonds from Firm A is satisfied by the size of Firm A's purchase of bonds within the same trading day, Firm A would be required to disclose on the customer confirmation the price to the firm (100), the price to the customer 102), and the differential between the two prices (2.00).

Example 5

- 10:00:00 AM Firm A purchases 500 XYZ bonds from a dealer at a price of 100 for $500,000.
- 10:15:00 AM Firm A sells 500 XYZ bonds to a customer at a price of 102.50 for $512,500.

Firm A would not be required to disclose the proposed pricing information on the customer confirmation because the size of the customer transaction exceeds the qualifying size disclosure threshold of 100 bonds or less.

Example 6

- 10:00:00 AM Firm A purchases 50 XYZ bonds from Customer 1 at a price of 98 for $49,000.
- 10:30:00 AM Firm A sells 50 XYZ bonds to Customer 2 at a price of 102 for $51,000.

Firm A would have disclosure requirements under the proposal to both customers. For Customer 1, Firm A would disclose the price to the firm (102), the price to the customer (98) and the differential between the two prices (4.00). For Customer 2, Firm A would disclose the price to the firm (98), the price to the customer (102) and the differential between the two prices (4.00).

Example 7

- 10:00:00 AM Firm A purchases 40 XYZ bonds from a dealer at a price of 100 for $40,000.
- 15:30:00 PM Firm A purchases 60 XYZ bonds from another dealer at a price of 99 for $59,500.
- 15:45:00 PM Firm A sells 100 XYZ bonds to 1 customer at a price of 99.70 for $99,700.

Where multiple firm trades equal the amount of the customer trade, Firm A would be required to disclose on the customer confirmation the weighted average price of the firm trades to the firm (99.40), the price to the customer (99.70), and the differential between the two prices (0.30). Note: In this example, the two firm trades are the equivalent of the customer trade and therefore a weighted average price would be used. Example 9 below provides a scenario where there are multiple transactions as principal that could form the basis of the firm's corresponding transaction(s) with its customers.

Example 8

- 10:00:00 AM Firm A purchases 100 XYZ bonds from a dealer at a price of 100 for $100,000.
- 10:15:00 AM Firm A sells 70 XYZ bonds to one customer at a price of 100 for $70,000.

Firm A would be required to disclose on the customer confirmation the price to the firm (100), the price to the customer (100), and the differential between the two prices (0).

Example 9

- 10:00:00 AM Firm A purchases 200 XYZ bonds from a dealer at a price of 102.50 for $205,000.
- 10:30:00 AM Firm A purchases 100 XYZ bonds from a dealer at a price of 104 for $104,000.
- 13:30:00 PM Firm A purchases 500 XYZ bonds as part of an institutional trade at a price of 103.50 for $517,500.
- 15:00:00 PM Firm A sells 100 XYZ bonds to a customer at a price of 104.50 for $104,500.

Where the firm engages in multiple transactions as principal that form the basis of its transactions with customers but exceed the number of bonds of the customer trade, FINRA expects that the firm would consistently apply a last in, first out (LIFO) methodology that would refer to the last principal trade(s) that preceded the customer trade. Firm A would therefore be required to disclose on the customer confirmation the price to the firm of the last transaction (103.50), the price to the customer (104.50), and the differential between the two prices (1).

Example 10

- 10:00:00 AM Firm A sells 100 XYZ bonds to a customer at a price of 102 for $102,000.
- 10:15:00 AM Firm A buys 500 XYZ bonds from a dealer at a price of 100 for $500,000.
- 10:30:00 AM Firm A buys 200 XYZ bonds from a dealer at a price of 101 for $202,000.

Where the firm engages in multiple transactions as principal that form the basis of its transactions with customers but exceed the number of bonds of the customer trade, FINRA expects that, in this scenario, the firm would consistently apply a methodology that would refer to the principal trade(s) in closest time proximity to the customer trade. Firm A would therefore be required to disclose on the customer confirmation the price to the firm of its first purchase (100), the price to the customer (102), and the differential between the two prices (2).

Example 11

- 15:30:00 PM (Trading Day 1) Firm A purchases 50 XYZ bonds from a dealer at a price of 100 for $50,000.
- 10:00:00 AM (Trading Day 2) Firm A purchases 50 XYZ bonds from a dealer at a price of 102.50 for $51,250.
- 10:15:00 AM (Trading Day 2) Firm A sells 50 XYZ bonds to 1 customer at a price of 103 for $51,500.

Since the transaction involved the same-day purchase of 50 bonds by the customer, Firm A would be required to disclose on the customer confirmation the price to the firm (102.50), the price to the customer (103), and the differential between the two prices (0.50). The transaction that occurred on the previous trading day (Trading Day 1) would not be incorporated into the price disclosure.

Example 12

- 15:30:00 PM (Trading Day 1) Firm A purchases 200 XYZ bonds from a dealer at a price of 104 for $208,000.
- 10:15:00 AM (Trading Day 2) Firm A sells 100 XYZ bonds to a customer at a price of 106 for $106,000.

Firm A would not be required to disclose the pricing information on the customer confirmation since Firm A's position was acquired on a previous trading day before it was sold to the customer, and is therefore not subject to the disclosure requirement.

Example 13

- 15:30:00 PM (Trading Day 1) Firm A purchases 50 XYZ bonds from a dealer at a price of 100 for $50,000.
- 10:00:00 AM (Trading Day 2) Firm A purchases 50 XYZ bonds from a dealer at a price of 101.50 for $50,750.
- 10:15:00 AM (Trading Day 2) Firm A sells 100 XYZ bonds to 1 customer at a price of 102 for $102,000.

Firm A would not be required to disclose the pricing information on the customer confirmation since the customer order could only be filled by the positions in XYZ that Firm A had acquired over two trading days. The transaction is therefore not subject to the disclosure requirement.

Economic Impact Analysis

Need for the Rule

FINRA is concerned that investors in fixed income securities currently are limited in their ability to understand and compare transaction costs.[13] FINRA believes that furnishing additional pricing-related information to customers as part of the customer confirmation will provide customers with meaningful and useful information.

Economic Baseline

The proposed disclosure will likely affect both broker-dealers and retail investors that engage in transactions in fixed income securities. Under SEC Rule 10b-10 and current FINRA rules, a broker-dealer acting as principal for its own account and trading fixed income securities with a customer is not required to disclose the difference between the price to the customer and the price of the broker-dealer's offsetting trade(s). In the absence of the proposal, customers would not be able to ascertain with certainty the specific price to the broker-dealer in connection with a customer trade.

Retail customers currently receive some of the information considered in this proposal. Specifically, confirmation statements already include the price of bonds purchased. But the confirmation is not required to include information about the cost of the security to the firm. FINRA is aware that some broker-dealers may provide an indication of market value of the bond as part of the confirmation, where that market value reflects either a recent transaction price or a valuation for bonds that have not otherwise traded in close proximity to the customer trade.

As previously noted, FINRA makes TRACE data available to the public, and retail customers may have access to recent trading histories through free finance Web portals, such as Yahoo Finance or FINRA's own website. But it is not possible to determine the value of the specific securities offered to the customer from the public sources.

Benefits

FINRA believes this additional pricing information will better enable customers to evaluate the cost and quality of the services firms provide by assisting customers in monitoring current same-day prices a firm and a customer pays or receives in connection with a transaction. The proposal will provide customers with pricing information that customers cannot currently obtain through TRACE data. FINRA further believes this type of information will promote transparency into firms' pricing practices and encourage communications between firms and their customers about pricing of their fixed income transactions. This proposal also may provide customers with additional information that may assist them in detecting practices that are possibly improper, which would supplement FINRA's own surveillance and enforcement program.[14]

Costs

FINRA recognizes that the proposal would impose burdens and costs on firms. Specifically, FINRA expects that the proposal would require firms to modify their systems to identify instances where firm and customer trades in the same security occur on the same trading day and to adopt a methodology to satisfy the disclosure requirement. Firms may need to record and monitor the decisions on the disclosure methodology. Firms would have to adopt compliance policies and procedures to ensure consistent and appropriate application of the methodology. Firms would also be required to calculate the price difference between the customer and firm trade, and to convey the firm price and differential to the customer price on the customer confirmation. FINRA understands some firms may use legacy systems for confirmations which may be costly to reprogram. FINRA staff will estimate the costs based on the information obtained through the public comment process.

FINRA is requesting comment on the potential for the proposal to have an unintended negative impact on market behavior, such as whether the proposal could result in decreased liquidity in the fixed income market, for example, if firms were less likely to hold bonds in inventory, or if firms would reduce service in retail-size trades. Specifically, FINRA is seeking evidence of the likelihood and size of such an impact. FINRA also is soliciting comment on whether the proposal could create confusion for investors where an investor receives the proposed disclosure for some transactions (*e.g.*, below the proposed size threshold and the firm and customer trades occur on the same trading day), but not for other transactions (*e.g.*, above the proposed size threshold or where the firm and customer trades did not occur on the same trading day).

Regulatory Alternatives

FINRA also recognizes that there are alternatives to the proposed approach of requiring disclosure of pricing information for trades in the same security where the firm and the customer trades occur on the same trading day. For example, another possible approach would be to require disclosure of the same pricing information, but limited to "riskless principal" trades, which would be consistent with the amendments to Rule 10b-10 that were previously proposed by the SEC.[15]

FINRA believes that there are increased benefits to requiring disclosure of pricing information for all trades in the same security where the firm and the customer trades occur on the same trading day, rather than limiting the proposal to only riskless principal trades. For example, FINRA believes using the proposed approach would result in the disclosure of pricing information for more retail-size trades, and that limiting the proposal to riskless principal transactions would exclude transactions where the pricing information would be valuable to the customer.[16] FINRA also believes that, in trades in the same security where the firm and the customer trades occur on the same trading day, most of these trades occur in close time proximity to each other, which minimizes concerns that intervening news or market movement that occur between the component trades would create a corresponding change in the price differential between the components.[17] FINRA believes that the close time proximity of the trades further supports that the pricing information would be valuable to investors.

In addition, FINRA believes that the proposed approach may allow for a more mechanical approach by firms than the riskless principal or marking approaches, which may require firms to conduct a trade-by-trade analysis to determine whether a specific trade was riskless or not. FINRA therefore believes that the proposed approach will provide more certainty to firms regarding their confirmation disclosure obligations. To the extent there are questions as to the methodology a firm uses to determine whether a trade is subject to the disclosure requirement, especially where a firm engages in multiple transactions as principal that form the basis of its corresponding transactions with customers, FINRA is specifically soliciting comment on such question as set forth in the Request for Comments section below.

FINRA also appreciates the potential complexities of requiring confirmation disclosure for trades in the same security where the firm and the customer trades occur on the same trading day, especially from an operational perspective. Another alternative may be to require a firm to disclose on customer confirmations for principal retail-size bond trades the mark-up in the transaction based on a reasonable marking methodology consistently used by the firm in valuing the bonds for internal and other regulatory purposes. For near-time offsetting trades, the marking methodology would presumptively use cost unless a reasonable basis for using another price can be demonstrated. As set forth in the Request for Comments section below, FINRA is specifically soliciting comment on whether an alternative approach would be preferable to the proposed concept.

As set forth above, FINRA recognizes that there are alternative forms and data points of pricing information that may be disclosed to retail customers, and specifically requests comment on such alternatives. Of the options that were considered, however, FINRA believes that, in trades in the same security where the firm and the customer trades occur on the same trading day, requiring firms to disclose the price to the firm, the price to the customer, and the corresponding differential will provide customers with comprehensive and beneficial information, while balancing the costs and burdens to firms of providing the disclosure.

Request for Comments

FINRA seeks comments on all aspects of the proposal as outlined above. In addition to general comments, FINRA specifically requests comments on the following questions. FINRA requests data and quantified comments where possible.

1. What are the anticipated benefits to investors of providing the proposed disclosure?
   - Would the proposed disclosures better enable customers to evaluate the cost and quality of the services firms provide, and help ensure customers receive fair and reasonable prices?
   - Would the proposed disclosures provide investors with greater transparency into the compensation of their brokers or the costs associated with the execution of their fixed income trades?
2. What kinds of costs would this requirement impose on firms, including the anticipated costs to firms in developing and implementing systems to comply with the proposal?
   - What are the estimates of these costs and what are the assumptions that underlie those estimates? Are the estimates different for firms of different sizes and different business models?
3. In addition to systems modifications, are there other potential changes to firms' infrastructure that would be necessary? What are those modifications?
4. For which transactions should pricing disclosures be made?
   - Does the proposal address the universe of transactions that should require confirmation disclosure?
   - Should the proposal be expanded beyond corporate bonds and agency debt to apply to other categories of fixed income securities? If so, why, and if not, why not?
   - Is it appropriate to only require a dealer to disclose pricing information when the customer trade is a retail trade? If so, should retail be defined by reference to the trade size, as in the proposal, or by some other standard, such as retail customers?
   - Should the proposal be expanded to require the disclosure of pricing information for transactions where the customer trade is of qualifying size (100 bonds or less or bonds with a face amount of $100,000 or less), and where the firm trade is for a number of bonds that is less than the customer trade?
   - Should there be any exclusions for certain types of transactions, notwithstanding the fact that they are retail-sized transactions? For example, should the proposed disclosures not be required for new issue trades?
   - How would alternatives impact the costs and benefits of the proposal?

5. Are there alternative forms of disclosure or methods to achieve the objectives of the proposal and are they better suited than the proposal?
   - Should the disclosure include the percentage of the price differential or the firm's mark-up or mark-down on the transaction? Would the objectives of the proposal be achieved if a firm was only required to disclose the price paid or received by the firm in its transaction with a third party, and not the corresponding differential?
   - Should the disclosure include a total dollar amount differential (*i.e.*, a differential that calculates the total dollar amount differential based on the number of bonds purchased or sold by the customer), rather than solely the proposed price differential? What are potential benefits and drawbacks of using such a differential? To illustrate this possible approach, Example 1 above would be revised as follows:

     10:00:00 AM Firm A purchases 50 XYZ bonds from a dealer at a price of 100 for $50,000.

     10:00:15 AM Firm A sells 50 XYZ bonds to one customer at a price of 102 for $51,000.

     Firm A would be required to disclose on the customer confirmation the price to the firm (100), the price to the customer (102) and the total dollar amount differential between the two trades ($1,000). The total dollar amount differential is calculated by multiplying the differential between the prices of the firm and the customer trades (2) by the number of bonds in the customer trade (50) by a multiplier of 10.
   - Rather than using the price to the firm, would the best available representation of current market price be more useful, particularly where the firm-side and customer-side transactions do not occur close in time? If so, given the infrequent trading in many bonds, what would be an acceptable reference price to use to measure the current market price?
   - As mentioned previously, FINRA could require a firm to disclose on customer confirmations for principal retail-size bond trades the mark-up in the transaction based on a reasonable marking methodology consistently used by the firm in valuing the bonds for internal and other regulatory purposes. For near-time offsetting trades, the marking methodology would presumptively use cost unless a reasonable basis for using another price can be demonstrated.
   - What would be the costs to firms to implement such an alternative disclosure? What are the assumptions that underlie those cost estimates?

6. To what extent, if any, do firms already provide or make available such information or similar information to customers in any format? Should the proposal allow for alternative methods, if they provide substantially similar pricing information to customers?

7. Should the concept of a "riskless principal" transaction be used in place of the proposed concept, and, if so, can "riskless principal" be defined in a manner that minimizes concerns that market participants would avoid the proposed disclosure requirements?
   - Would it be feasible to define a riskless principal transaction for purposes of this proposal to include instances where a firm executed a buy or sell order while holding a potentially offsetting "soft" or "firm" order?
   - Would it be feasible to define a riskless principal transaction to include instances where a firm held inventory for a specified length of time before the customer order was received, or instances where the offsetting trade occurred within 30 minutes of the first trade, assuming the firm was promptly reporting its trades?
   - What would be the costs to firms to implement such an alternative disclosure? What are the assumptions that underlie those cost estimates?

8. Should disclosure be subject to a *de minimis* standard, *e.g.*, disclosure of a price differential below a specified threshold would not be required? If so, how should the existence of the threshold be communicated to customers so the customers understand that the trades have a differential? How would such a *de minimis* standard impact the costs and benefits associated with the proposal?

9. When a firm executes multiple transactions as principal, which then form the basis of the firm's corresponding transactions with its customers, is the last in, first out (LIFO) approach the most appropriate methodology to use?
   - Would it be appropriate to allow firms to have flexibility to establish their own methodology, consistent with the objectives of the proposal, which would be documented by the firm in its written policies and procedures and consistently applied? For example, is it appropriate to allow firms to utilize a reference price that is based on a same-day principal trade that does not meet the LIFO standard, where the size of that principal trade is more equivalent to the size of the customer trade? What other approaches might a firm adopt?

10. When a firm executes a transaction as principal with a customer, such as in Example 6, where the firm buys 50 XYZ bonds from one customer and then sells 50 XYZ bonds to another customer, FINRA understands that the price paid to the customer may not represent the firm's true price of the trade, *e.g.*, it may reflect a mark-down. For purposes of the proposed disclosure requirement, should firms be allowed to use a different price as the reference price in this scenario, assuming the firm is able to justify and document its decision?

11. Are there other potential effects to markets and market participants of the proposal?

- Would the proposal alter the incentives and dynamics of the broker-customer relationship, cause firms to reduce service in retail-sized trades, or encourage firms to trade with customers as principal from inventory?
- Would applying the proposal to a limited set of securities on a pilot basis provide useful information, including whether firm behavior would change as a result of the disclosure requirement?
- How should FINRA measure and assess these potential effects against the benefits the proposal might create?

12. Would it be appropriate or beneficial for firms to supplement the proposed disclosures by providing customers with an explanation of the pricing information or to provide customers with additional information relevant to execution quality? If so, what kind of documentation would be appropriate for this purpose? Should this practice be permitted or required?

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See* note 16 *infra*.
4. *See* note 13 *infra*.
5. *See* U.S. Securities and Exchange Commission, Report on the Municipal Securities Market, dated July 31, 2012.
6. As noted above, the MSRB is publishing a similar proposal regarding disclosure of information by dealers to their retail customers to help them independently assess the prices they are receiving from dealers and to better understand some of the factors associated with the costs of their transactions. The MSRB's proposal also broadly seeks input on alternative regulatory approaches, including mark-up and mark-down disclosure on confirmations for trades that could be considered riskless principal transactions.

   A mark-down is the amount by which the price of a security is reduced from the prevailing market price. A mark-up is the amount in excess of the prevailing market price that a customer pays a dealer when purchasing a security.

7. *See* speech by Chair White, dated June 20, 2014, *Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors*, Economic Club of New York, New York, NY.

8. MSRB Rule G-15 governs customer confirmations for transactions in municipal securities.

9. SEC Rule 10b-10 governs confirmations that must be delivered to customers in connection with transactions in equity and fixed income securities, except municipal securities. That rule generally requires that a broker-dealer acting in an agency capacity disclose the amount of any remuneration received or to be received from its customer in connection with a transaction in equity or fixed income securities. *See* 17 CFR 240.10b-10(a)(2)(i). When a broker-dealer is acting as principal, however, the disclosure requirements related to pricing information are different for equity and fixed income securities. When a broker-dealer is acting in a riskless principal capacity, Rule 10b-10 only requires a broker-dealer to disclose the amount of its mark-up or mark-down for transactions in equity securities. *See* 17 CFR 240.10b-10(a)(2)(ii). As a result, a customer receives different pricing information on its transaction confirmation depending on the type of security it is buying or selling.

   FINRA rules also require that firms send transaction confirmations to customers, but do not impose any additional disclosure requirements on firms related to pricing information beyond what is required under SEC Rule 10b-10. Rule 2232 requires that a member send a customer confirmation before or upon completion of a transaction for or with a customer, in accordance with the requirements of SEC Rule 10b-10. See Rule 2232(a). In addition, FINRA rules governing mark-ups and mark-downs set forth standards by which the amount of a mark-up or mark-down may be assessed, but do not require members to disclose the amount of the mark-up or mark-down. *See* Rule 2121.

10. The rule defines a "corporate debt security" as a debt security that is United States (U.S.) dollar-denominated and issued by a U.S. or foreign private issuer and, if a "restricted security" as defined in Securities Act Rule 144(a)(3), sold pursuant to Securities Act Rule 144A, but does not include a Money Market Instrument as defined in Rule 6710(o). An "agency debt security" shall have the same meaning as in Rule 6710(l). The proposal would not apply to transactions in asset-backed securities, as defined in Rule 6710(m).

11. As indicated previously, under Rule 10b-10, firms are already required to disclose on confirmations the price of the security that was bought or sold by the customer.

12. Each of the following examples assumes a par value of $1,000 per bond. The disclosure requirements for bonds with a par value greater than $1,000 may vary, based on the number of bonds traded.

13. Currently, customers may use TRACE to determine pricing information for a fixed income security that is eligible for TRACE reporting, including the last trade price, execution time and execution quantity, using either the issuer's name or the CUSIP number. While this information may provide the customer with a useful basis of comparison for its transaction, a customer would not be able to use TRACE data to ascertain with certainty the specific price to its broker-dealer in connection with its trade, or the actual amount of the mark-up or mark-down incurred in connection with its trade.

In addition, investors would need to possess a certain degree of knowledge and skill to access and derive relevant information from TRACE. Therefore, existing TRACE data alone may not assist customers in fully understanding their trading costs.

14. *See* Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767 (March 17, 1994) (noting the functions of the transaction confirmation).

15. *See* Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767 (March 17, 1994). For purposes of requiring disclosure in equity securities where a broker or dealer is acting as principal for its own account, Rule 10b-10 requires disclosure where a broker or dealer, "after having received an order to buy from a customer . . . purchased the equity security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the broker or dealer sold the security to another person to offset a contemporaneous purchase from such customer." *See* 17 CFR 240.10b-10(a)(2)(ii).

16. Using TRACE data from 3Q13, FINRA has observed that the proposed approach would have resulted in 41 percent more retail-size trades receiving pricing information. FINRA has also observed that, using TRACE data from 2013, the price differentials for customer buy and sell orders (which can be an indicator of the firm's mark-up and mark-down practices), were of varying amounts within similar sized trades, and that varying price differentials were not limited to riskless principal trades. FINRA therefore believes that the disclosure of pricing information should apply to a wider range of customer transactions, and should not be limited to riskless principal trades.

    For example, for transactions of 10 to 40 bonds (or 10,000 to 40,000 par amount) in the Investment Grade category, the median calculated differential on customer sell orders was .42 percent, but the 95th percentile was 1.49 percent and the 99th percentile was 2.29 percent. For transactions of 40 to 70 bonds (or 40,000 par amount to 70,000 par amount) in the Investment Grade category, the median calculated differential was .38 percent, but the 95th percentile was 1.49 percent and the 99th percentile was 2.29 percent.

    Similarly, with respect to the calculated differential on customer buy orders, for transactions of 10 to 40 bonds (or 10,000 to 40,000 par amount) in the Investment Grade category, the median calculated differential on customer buy orders was .66 percent, but the 95th percentile was 2.15 percent and the 99th percentile was 2.71 percent. For transactions of 40 to 70 bonds (or 40,000 to 70,000 par amount) in the Investment Grade category, the median calculated differential was .63 percent, but the 95th percentile was 2.08 percent and the 99th percentile was 2.76 percent.

    This difference was also present in high yield and unrated securities.

17. TRACE data from 3Q13 also indicated that approximately 95 percent of the same-day trades occurred within 30 minutes of each other.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

FINRA Rules

2230. Customer Account Statements and Confirmations

2232. Customer Confirmations

(a) A member shall, at or before the completion of any transaction in any security effected for or with an account of a customer, give or send to such customer written notification ("confirmation") in conformity with the requirements of SEA Rule 10b-10.

(b) A confirmation given or sent pursuant to this Rule shall further disclose:

(1) with respect to any transaction in any NMS stock, as defined in Rule 600 of SEC Regulation NMS, or any security subject to the reporting requirements of the FINRA Rule 6600 Series, other than direct participation programs as defined in FINRA Rule 6420, the settlement date of the transaction; [and]

(2) with respect to any transaction in a callable equity security, that:

(A) the security is a callable equity security; and

(B) a customer may contact the member for more information concerning the security[.]<u>; and</u>

<u>(3) with respect to a sale to (purchase from) a customer of Qualifying Size involving a corporate or agency debt security, where the member also executes a buy (sell) transaction(s) as principal with one or multiple parties in the same security within the same trading day where the size of the principal transaction(s) executed on the same trading day would meet or exceed the size of the customer transaction:</u>

<u>(A) the price to the member;</u>

<u>(B) the price to the customer; and</u>

<u>(C) the differential between the two prices in (A) and (B).</u>

<u>(c) Definitions</u>

<u>For purposes of this Rule, the term:</u>

(1) “corporate debt security” shall mean a debt security that is United States (“U.S.”) dollar-denominated and issued by a U.S. or foreign private issuer and, if a “restricted security” as defined in Securities Act Rule 144(a)(3), sold pursuant to Securities Act Rule 144A, but does not include a Money Market Instrument as defined in Rule 6710(o) or an Asset-Backed Security as defined in Rule 6710(m);

(2) “agency debt security” shall have the same meaning as in Rule 6710(l); and

(3) “Qualifying Size” shall mean a transaction for the purchase or sale of 100 bonds or less or bonds with a face amount of $100,000 or less, based on reported quantity.

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