

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * 36	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4		File No.* SR - 2015 - * 033	Amendment No. (req. for Amendments *)
Filing by Financial Industry Regulatory Authority Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934				
Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input checked="" type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>
			Section 19(b)(3)(B) * <input type="checkbox"/>	
			Rule	
Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1) <input type="checkbox"/> 19b-4(f)(2) <input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(4) <input type="checkbox"/> 19b-4(f)(5) <input type="checkbox"/> 19b-4(f)(6)
Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010			Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934	
Section 806(e)(1) * <input type="checkbox"/>	Section 806(e)(2) * <input type="checkbox"/>	Section 3C(b)(2) * <input type="checkbox"/>		
Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>			
<b>Description</b>				
Provide a brief description of the action (limit 250 characters, required when Initial is checked *).				
<input type="text" value="Proposed Rule Change to Amend FINRA Rule 0150 to Apply FINRA Rule 2121 and its Supplementary Material .01 and .02 to Transactions in Exempted Securities That Are Government Securities"/>				
<b>Contact Information</b>				
Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.				
First Name *	<input type="text" value="Andrew"/>	Last Name *	<input type="text" value="Madar"/>	
Title *	<input type="text" value="Associate General Counsel"/>			
E-mail *	<input type="text" value="andrew.madar@finra.org"/>			
Telephone *	<input type="text" value="(202) 728-8056"/>	Fax	<input type="text" value="(202) 728-8264"/>	
<b>Signature</b>				
Pursuant to the requirements of the Securities Exchange Act of 1934,				
has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.				
(Title *)				
Date	<input type="text" value="09/17/2015"/>	<input type="text" value="Senior Vice President and Director of Capital Markets Policy"/>		
By	<input type="text" value="Stephanie M. Dumont"/>	<input type="text" value="Stephanie Dumont,"/>		
(Name *)				
NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.				

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFF website.

**Form 19b-4 Information \***

Add Remove View

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change \***

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies \***

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

Add Remove View

Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

Add Remove View

Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

Add Remove View

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

Add Remove View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of the Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> Financial Industry Regulatory Authority, Inc. (“FINRA”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend FINRA Rule 0150, Application of Rules to Exempted Securities Except Municipal Securities, so that FINRA Rule 2121 and its Supplementary Material .01 and .02, which govern mark-ups and commissions, will apply to transactions in exempted securities that are government securities.

Below is the text of the proposed rule change. Proposed new language is underlined.

\* \* \* \* \*

**0100. GENERAL STANDARDS**

\* \* \* \* \*

**0150. Application of Rules to Exempted Securities Except Municipal Securities**

(a) through (c) No Change.

(d) FINRA Rule 2121 is applicable to transactions in, and business activities relating to, exempted securities that are government securities.

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

---

<sup>1</sup> 15 U.S.C. 78s(b)(1).

**2. Procedures of the Self-Regulatory Organization**

At its meetings on July 12, 2012, and April 16, 2015, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

If the Commission approves the proposed rule change, the proposed rule change will be effective upon Commission approval.

**3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

(a) Purpose

Rule 0150(c) enumerates the FINRA rules and the rules of the National Association of Securities Dealers (“NASD”) that apply to transactions in, and business activities relating to, exempted securities, except municipal securities, conducted by members and associated persons.<sup>2</sup> Currently, this rule does not include Rule 2121, Supplementary Material .01, or Supplementary Material .02, which govern mark-ups and commissions (“mark-up rule”).<sup>3</sup>

---

<sup>2</sup> The terms exempted securities, government securities, and municipal securities are defined in Sections 3(a)(12), 3(a)(42), and 3(a)(29) of the Act, respectively. The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (“Dual Members”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

<sup>3</sup> NASD Rule 2440, IM-2440-1, and IM-2440-2 were recently moved to the FINRA rules without any substantive changes, becoming Rule 2121, Supplementary Material .01, and Supplementary Material .02, respectively. See Securities

The basis for not applying certain FINRA and NASD rules, including the mark-up rules, to exempted securities (except municipal securities) is largely historical. Prior to 1993, there were statutory limitations on NASD's ability to apply sales practice rules, including the mark-up rules, to transactions in exempted securities. Specifically, Section 15A(f) of the Act imposed limitations on the authority of registered securities associations over transactions by a registered broker or dealer in an exempted security.<sup>4</sup> This provision was eliminated as part of the Government Securities Act Amendments of 1993 ("GSAA").<sup>5</sup> Following the GSAA, the NASD proposed to apply certain NASD rules to exempted securities other than to municipal securities, although it did not propose to apply the mark-up rule then in effect (NASD Rule 2440 and IM-2440-1) to such

---

Exchange Act Release No. 72208 (May 21, 2014), 79 FR 30675 (May 28, 2014) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2014-023).

<sup>4</sup> Prior to 1986, Section 15A(f) provided that "[n]othing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security." See 15 U.S.C. § 78o-3 (historical notes).

In 1986, the Government Securities Act of 1986 ("GSA") was enacted, which established a federal system for the regulation of brokers and dealers who transact business in government securities and certain other exempted securities. See Government Securities Act of 1986, Pub. L. No. 99-571, 100 Stat. 3208 (1986). The GSA, among other things, amended Section 15A(f) to provide that, "[e]xcept as provided in paragraph (2) of this subsection, nothing in this section shall be construed to apply with respect to any transaction by a registered broker or dealer in any exempted security." See Government Securities Act of 1986, Pub. L. No. 99-571, §102(g)(1), 100 Stat. 3208 (1986). Paragraph (f)(2), which was added by the GSA, provided that a registered securities association could adopt and implement rules with respect to exempted securities to (1) enforce members' compliance with the relevant provisions of the Act and rules and regulations thereunder, (2) adequately discipline its members, (3) inspect members' books and records, and (4) prohibit fraudulent, misleading, deceptive and false advertising. Id.

<sup>5</sup> See Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 106(b)(1), 107 Stat. 2344 (1993).

securities.<sup>6</sup> Rather, the NASD stated that it intended to review the specific application of these rules to the government securities market and that it was developing an interpretation of the mark-up rule with respect to exempted securities and other debt securities.<sup>7</sup> The NASD further stated that actions for conduct generally encompassed by the NASD mark-up rule in the government securities market could be brought under NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade).<sup>8</sup> In 2001, NASD adopted Rule 0116 (now FINRA Rule 0150), which set forth the NASD rules that would apply to transactions in exempted securities, except municipal securities.<sup>9</sup> In 2007, the SEC approved IM-2440-2, which set forth a mark-up policy for transactions in debt securities, except municipal securities.<sup>10</sup>

---

<sup>6</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39).

<sup>7</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100, 44104 nn.3-4 (August 27, 1996).

<sup>8</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR at 44113 (noting that Amendment No. 5 to the proposal “clarifies and reminds members that [NASD] rules requiring members to adhere to just and equitable principles of trade apply to conduct that may violate the Fair Prices and Commissions provision and the Mark-Up Policy.”)

NASD Rule 2110 has since been adopted as FINRA Rule 2010. See Securities Exchange Release No. 58643 (September 25, 2008), 73 FR 57174 (October 1, 2008) (Order Approving File No. SR-FINRA-2008-028).

<sup>9</sup> See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Order Approving File No. SR-NASD-00-38).

<sup>10</sup> See Securities Exchange Act Release No. 55638 (April 16, 2007), 72 FR 20150 (April 23, 2007) (Order Approving File No. SR-NASD-2003-141). As noted above, NASD Rule 2440, IM-2440-1, and IM-2440-2 were recently moved to the FINRA rulebook without any substantive changes, becoming FINRA Rule 2121, Supplementary Material .01, and Supplementary Material .02, respectively. See supra note 3.

FINRA is now proposing to amend Rule 0150 so that Rule 2121, along with Supplementary Material .01 and .02, would apply to transactions in, and business activities relating to, exempted securities that are government securities, as defined in Section 3(a)(42) of the Exchange Act.<sup>11</sup> FINRA believes that amending Rule 0150 to apply the mark-up rule to transactions in government securities is consistent with the GSAA. FINRA also believes that amending Rule 0150 in this manner is consistent with NASD's application of certain of its rules, following the GSAA, to exempted securities except for municipal securities.<sup>12</sup>

FINRA also notes the regulatory benefits of applying the mark-up rule to government securities. Under current rules, if FINRA staff wishes to bring a case alleging excessive mark-ups, mark-downs or commissions in transactions in exempted securities other than municipal securities, such as agency debt securities or U.S. Treasury securities, FINRA must bring the case under Rule 2010. Amending Rule 0150 to apply the mark-up rule to transactions and business activities relating to government securities would provide a specific cause of action under which conduct involving such securities could be regulated, in addition to the more general provisions of Rule 2010. As such, this proposed rule change would clearly signal to members that conduct relating to mark-ups and commissions in the market for government securities directly implicates the mark-up rule, in addition to Rule 2010. FINRA also notes that the mark-up rule provides specific

---

<sup>11</sup> This includes U.S. Treasury securities, as defined in FINRA Rule 6710(p). As defined in Rule 6710(p), a U.S. Treasury Security means a "security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities."

<sup>12</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39).

criteria by which members should assess debt mark-ups and mark-downs.<sup>13</sup> Amending Rule 0150 to apply these standards to transactions in government securities would provide both members and FINRA staff with clearer standards by which to measure the propriety of mark-ups, mark-downs and commissions in such transactions.

As a practical matter, FINRA believes that amending Rule 0150 to apply to government securities would have little impact upon members. Rule 2010 already governs transactions in government securities, which would include instances of improper or excessive mark-ups, mark-downs or commissions. Although this proposal would apply the more specific provisions of the mark-up rule to transactions involving government securities, these provisions are already applicable to corporate debt securities. Member firms that currently engage in transactions in corporate debt will therefore already be familiar with the application of the mark-up rule, and FINRA believes that most firms apply substantially similar standards to transactions in all fixed income securities.

FINRA also does not believe that this proposal will impact the reporting or surveillance of transactions in government securities. FINRA currently requires members to report transactions in many government securities (*i.e.*, agency debentures and agency asset-backed securities) to its Trade Reporting and Compliance Engine (“TRACE”), and actively surveils the markets in such securities. For those government securities that are not TRACE-eligible, such as U.S. Treasury securities, any review of

---

<sup>13</sup> See Rule 2121, Supplementary Material .02 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities).



transactions in such securities pursuant to the mark-up rule would occur as it does today, e.g., through a manual process that is part of FINRA's regular examination cycle.

FINRA notes that, following the end of the comment period for this proposal, it will consult with the U.S. Department of the Treasury with respect to the application of the mark-up rule to transactions in government securities that are U.S. Treasury securities.<sup>14</sup>

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, the proposed rule change will be effective upon Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>15</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest, and Section 15A(b)(9) of the Act,<sup>16</sup> which requires that FINRA rules not impose any burden on competition that is not necessary or appropriate. FINRA believes that amending Rule 0150 so that the mark-up rule will apply to government securities is consistent with the Act, because government securities can be subject to instances of

---

<sup>14</sup> FINRA also notes that, pursuant to Section 19(b)(5) of the Act, the SEC "shall consult with and consider the views of the Secretary of the Treasury prior to approving a proposed rule filed by a registered securities association that primarily concerns conduct related to transactions in government securities, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor." See 15 U.S.C. 78s(b)(5).

<sup>15</sup> 15 U.S.C. 78o-3(b)(6).

<sup>16</sup> 15 U.S.C. 78o-3(b)(9).

excessive mark-ups, and investors in government securities will therefore benefit from the specific application of the mark-up rule to that market. FINRA also believes that this proposal is consistent with both the GSAA and with NASD's subsequent application of certain of its rules to exempted securities except for municipal securities. FINRA also believes that the proposed rule change is consistent with the Act as it will provide FINRA with specific authority over instances of excessive mark-ups, mark-downs or commissions relating to government securities that may be pursued, in addition to the more general provisions of Rule 2010.

**4. Self-Regulatory Organization's Statement on Burden on Competition**

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA notes that the proposed rule change is designed to assist FINRA in meeting its regulatory obligations by extending the rule governing mark-ups and commissions to government securities. FINRA believes that the proposed rule change will have minimal impact on members, as FINRA currently requires members to report transactions in many government securities, and members that charge an excessive mark-up, markdown or commission in transactions in exempted securities are already subject to the provisions of Rule 2010.

**5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

Written comments were solicited in Regulatory Notice 13-07 but none were

received.<sup>17</sup>

**6. Extension of Time Period for Commission Action**

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.<sup>18</sup>

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)**

Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act**

Not applicable.

**10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act**

Not applicable.

**11. Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2. Regulatory Notice 13-07 (January 2013).

---

<sup>17</sup> In 2013, FINRA published Regulatory Notice 13-07, which sought comment on a proposed rule change that would have amended several aspects of the mark-up rule, including amending Rule 0150 to apply the mark-up rule to certain government securities. Although FINRA received eight comment letters in connection with this Regulatory Notice, none of those comment letters addressed the proposed rule change that is the subject of this rule filing. A copy of the Regulatory Notice is attached as Exhibit 2.

<sup>18</sup> 15 U.S.C. 78s(b)(2).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-FINRA-2015-033)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 0150 to Apply FINRA Rule 2121 and its Supplementary Material .01 and .02 to Transactions in Exempted Securities That Are Government Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 0150, Application of Rules to Exempted Securities Except Municipal Securities, so that FINRA Rule 2121 and its Supplementary Material .01 and .02, which govern mark-ups and commissions, will apply to transactions in exempted securities that are government securities.

Below is the text of the proposed rule change. Proposed new language is in italics.

---

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

\* \* \* \* \*

**0100. GENERAL STANDARDS**

\* \* \* \* \*

**0150. Application of Rules to Exempted Securities Except Municipal Securities**

(a) through (c) No Change.

(d) FINRA Rule 2121 is applicable to transactions in, and business activities relating to, exempted securities that are government securities.

\* \* \* \* \*

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Rule 0150(c) enumerates the FINRA rules and the rules of the National Association of Securities Dealers ("NASD") that apply to transactions in, and business activities relating to, exempted securities, except municipal securities, conducted by members and associated persons.<sup>3</sup> Currently, this rule does not include Rule 2121,

---

<sup>3</sup> The terms exempted securities, government securities, and municipal securities are defined in Sections 3(a)(12), 3(a)(42), and 3(a)(29) of the Act, respectively.

Supplementary Material .01, or Supplementary Material .02, which govern mark-ups and commissions (“mark-up rule”).<sup>4</sup>

The basis for not applying certain FINRA and NASD rules, including the mark-up rules, to exempted securities (except municipal securities) is largely historical. Prior to 1993, there were statutory limitations on NASD’s ability to apply sales practice rules, including the mark-up rules, to transactions in exempted securities. Specifically, Section 15A(f) of the Act imposed limitations on the authority of registered securities associations over transactions by a registered broker or dealer in an exempted security.<sup>5</sup>

---

The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (“Dual Members”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

<sup>4</sup> NASD Rule 2440, IM-2440-1, and IM-2440-2 were recently moved to the FINRA rules without any substantive changes, becoming Rule 2121, Supplementary Material .01, and Supplementary Material .02, respectively. See Securities Exchange Act Release No. 72208 (May 21, 2014), 79 FR 30675 (May 28, 2014) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2014-023).

<sup>5</sup> Prior to 1986, Section 15A(f) provided that “[n]othing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security.” See 15 U.S.C. § 78o-3 (historical notes).

In 1986, the Government Securities Act of 1986 (“GSA”) was enacted, which established a federal system for the regulation of brokers and dealers who transact business in government securities and certain other exempted securities. See Government Securities Act of 1986, Pub. L. No. 99-571, 100 Stat. 3208 (1986). The GSA, among other things, amended Section 15A(f) to provide that, “[e]xcept as provided in paragraph (2) of this subsection, nothing in this section shall be construed to apply with respect to any transaction by a registered broker or dealer in any exempted security.” See Government Securities Act of 1986, Pub. L. No. 99-571, §102(g)(1), 100 Stat. 3208 (1986). Paragraph (f)(2), which was added by the GSA, provided that a registered securities association could adopt and

This provision was eliminated as part of the Government Securities Act Amendments of 1993 (“GSAA”).<sup>6</sup> Following the GSAA, the NASD proposed to apply certain NASD rules to exempted securities other than to municipal securities, although it did not propose to apply the mark-up rule then in effect (NASD Rule 2440 and IM-2440-1) to such securities.<sup>7</sup> Rather, the NASD stated that it intended to review the specific application of these rules to the government securities market and that it was developing an interpretation of the mark-up rule with respect to exempted securities and other debt securities.<sup>8</sup> The NASD further stated that actions for conduct generally encompassed by the NASD mark-up rule in the government securities market could be brought under NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade).<sup>9</sup> In 2001, NASD adopted Rule 0116 (now FINRA Rule 0150), which set forth the NASD rules that

---

implement rules with respect to exempted securities to (1) enforce members’ compliance with the relevant provisions of the Act and rules and regulations thereunder, (2) adequately discipline its members, (3) inspect members’ books and records, and (4) prohibit fraudulent, misleading, deceptive and false advertising. Id.

<sup>6</sup> See Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 106(b)(1), 107 Stat. 2344 (1993).

<sup>7</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39).

<sup>8</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100, 44104 nn.3-4 (August 27, 1996).

<sup>9</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR at 44113 (noting that Amendment No. 5 to the proposal “clarifies and reminds members that [NASD] rules requiring members to adhere to just and equitable principles of trade apply to conduct that may violate the Fair Prices and Commissions provision and the Mark-Up Policy.”)

NASD Rule 2110 has since been adopted as FINRA Rule 2010. See Securities Exchange Release No. 58643 (September 25, 2008), 73 FR 57174 (October 1, 2008) (Order Approving File No. SR-FINRA-2008-028).

would apply to transactions in exempted securities, except municipal securities.<sup>10</sup> In 2007, the SEC approved IM-2440-2, which set forth a mark-up policy for transactions in debt securities, except municipal securities.<sup>11</sup>

FINRA is now proposing to amend Rule 0150 so that Rule 2121, along with Supplementary Material .01 and .02, would apply to transactions in, and business activities relating to, exempted securities that are government securities, as defined in Section 3(a)(42) of the Exchange Act.<sup>12</sup> FINRA believes that amending Rule 0150 to apply the mark-up rule to transactions in government securities is consistent with the GSAA. FINRA also believes that amending Rule 0150 in this manner is consistent with NASD's application of certain of its rules, following the GSAA, to exempted securities except for municipal securities.<sup>13</sup>

FINRA also notes the regulatory benefits of applying the mark-up rule to government securities. Under current rules, if FINRA staff wishes to bring a case alleging excessive mark-ups, mark-downs or commissions in transactions in exempted

---

<sup>10</sup> See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Order Approving File No. SR-NASD-00-38).

<sup>11</sup> See Securities Exchange Act Release No. 55638 (April 16, 2007), 72 FR 20150 (April 23, 2007) (Order Approving File No. SR-NASD-2003-141). As noted above, NASD Rule 2440, IM-2440-1, and IM-2440-2 were recently moved to the FINRA rulebook without any substantive changes, becoming FINRA Rule 2121, Supplementary Material .01, and Supplementary Material .02, respectively. See supra note 3.

<sup>12</sup> This includes U.S. Treasury securities, as defined in FINRA Rule 6710(p). As defined in Rule 6710(p), a U.S. Treasury Security means a "security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities."

<sup>13</sup> See Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39).



securities other than municipal securities, such as agency debt securities or U.S. Treasury securities, FINRA must bring the case under Rule 2010. Amending Rule 0150 to apply the mark-up rule to transactions and business activities relating to government securities would provide a specific cause of action under which conduct involving such securities could be regulated, in addition to the more general provisions of Rule 2010. As such, this proposed rule change would clearly signal to members that conduct relating to mark-ups and commissions in the market for government securities directly implicates the mark-up rule, in addition to Rule 2010. FINRA also notes that the mark-up rule provides specific criteria by which members should assess debt mark-ups and mark-downs.<sup>14</sup> Amending Rule 0150 to apply these standards to transactions in government securities would provide both members and FINRA staff with clearer standards by which to measure the propriety of mark-ups, mark-downs and commissions in such transactions.

As a practical matter, FINRA believes that amending Rule 0150 to apply to government securities would have little impact upon members. Rule 2010 already governs transactions in government securities, which would include instances of improper or excessive mark-ups, mark-downs or commissions. Although this proposal would apply the more specific provisions of the mark-up rule to transactions involving government securities, these provisions are already applicable to corporate debt securities. Member firms that currently engage in transactions in corporate debt will therefore already be familiar with the application of the mark-up rule, and FINRA believes that most firms apply substantially similar standards to transactions in all fixed income securities.

---

<sup>14</sup> See Rule 2121, Supplementary Material .02 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities).

FINRA also does not believe that this proposal will impact the reporting or surveillance of transactions in government securities. FINRA currently requires members to report transactions in many government securities (i.e., agency debentures and agency asset-backed securities) to its Trade Reporting and Compliance Engine (“TRACE”), and actively surveils the markets in such securities. For those government securities that are not TRACE-eligible, such as U.S. Treasury securities, any review of transactions in such securities pursuant to the mark-up rule would occur as it does today, e.g., through a manual process that is part of FINRA’s regular examination cycle.

FINRA notes that, following the end of the comment period for this proposal, it will consult with the U.S. Department of the Treasury with respect to the application of the mark-up rule to transactions in government securities that are U.S. Treasury securities.<sup>15</sup>

If the Commission approves the proposed rule change, the proposed rule change will be effective upon Commission approval.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>16</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote

---

<sup>15</sup> FINRA also notes that, pursuant to Section 19(b)(5) of the Act, the SEC “shall consult with and consider the views of the Secretary of the Treasury prior to approving a proposed rule filed by a registered securities association that primarily concerns conduct related to transactions in government securities, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor.” See 15 U.S.C. 78s(b)(5).

<sup>16</sup> 15 U.S.C. 78o-3(b)(6).

just and equitable principles of trade, and, in general, to protect investors and the public interest, and Section 15A(b)(9) of the Act,<sup>17</sup> which requires that FINRA rules not impose any burden on competition that is not necessary or appropriate. FINRA believes that amending Rule 0150 so that the mark-up rule will apply to government securities is consistent with the Act, because government securities can be subject to instances of excessive mark-ups, and investors in government securities will therefore benefit from the specific application of the mark-up rule to that market. FINRA also believes that this proposal is consistent with both the GSAA and with NASD's subsequent application of certain of its rules to exempted securities except for municipal securities. FINRA also believes that the proposed rule change is consistent with the Act as it will provide FINRA with specific authority over instances of excessive mark-ups, mark-downs or commissions relating to government securities that may be pursued, in addition to the more general provisions of Rule 2010.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA notes that the proposed rule change is designed to assist FINRA in meeting its regulatory obligations by extending the rule governing mark-ups and commissions to government securities. FINRA believes that the proposed rule change will have minimal impact on members, as FINRA currently requires members to report transactions in many government securities, and members that charge an excessive mark-up, markdown or

---

<sup>17</sup> 15 U.S.C. 78q-3(b)(9).

commission in transactions in exempted securities are already subject to the provisions of Rule 2010.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were solicited in Regulatory Notice 13-07 but none were received.<sup>18</sup>

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

---

<sup>18</sup> In 2013, FINRA published Regulatory Notice 13-07, which sought comment on a proposed rule change that would have amended several aspects of the mark-up rule, including amending Rule 0150 to apply the mark-up rule to certain government securities. Although FINRA received eight comment letters in connection with this Regulatory Notice, none of those comment letters addressed the proposed rule change that is the subject of this rule filing. A copy of the Regulatory Notice is attached as Exhibit 2.

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2015-033 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Robert W. Errett, Deputy Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2015-033. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You

should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2015-033 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>19</sup>

Robert W. Errett  
Deputy Secretary

---

<sup>19</sup> 17 CFR 200.30-3(a)(12).

# Regulatory Notice

# 13-07

## Markups, Commissions and Fees

### FINRA Requests Comment on Proposed FINRA Rules Governing Markups, Commissions and Fees

Comment Period Expires: April 1, 2013

#### Executive Summary

As part of the process to develop a new, consolidated rulebook (the Consolidated FINRA Rulebook),<sup>1</sup> FINRA is requesting comment on proposed FINRA rules governing markups, markdowns, commissions and fees. FINRA initially sought comment on the proposed rules in [Regulatory Notice 11-08](#). In response to the comments received, FINRA is proposing several changes to the proposed rules. These changes include, among other things, amendments to: (1) retain the 5% markup policy in NASD IM-2440-1 (Mark-Up Policy); (2) revise certain of the relevant factors used to determine the reasonableness of markups and commissions; (3) eliminate the requirement to provide commission schedules for equity securities transactions to retail customers; and (4) extend the proposed markup rules to transactions in certain government securities. This *Notice* requests comment on the revised proposal.

The text of the proposed rules can be found at [www.finra.org/notices/13-07](http://www.finra.org/notices/13-07).

Questions regarding this *Notice* should be directed to:

- ▶ Sharon Zackula, Associate Vice President & Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8985; and
- ▶ Erika Lazar, Assistant General Counsel, OGC, at (202) 728-8013.

#### January 2013

##### Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

##### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management

##### Key Topics

- ▶ 5% Policy
- ▶ Commissions
- ▶ Government Securities
- ▶ Markups and Markdowns
- ▶ Rulebook Consolidation
- ▶ Service Charges and Fees

##### Referenced Rules & Notices

- ▶ FINRA Rule 0150
- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2111
- ▶ NASD IM-2310-3
- ▶ NASD IM-2440-1
- ▶ NASD IM-2440-2
- ▶ NASD Rule 2430
- ▶ NASD Rule 2440
- ▶ NYSE Rule 375 and Interpretation 375/01
- ▶ Regulatory Notice 11-08
- ▶ SEA Section 3
- ▶ SEA Section 19

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 1, 2013.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto: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.<sup>2</sup>

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).<sup>3</sup>

## Background & Discussion

In [Regulatory Notice 11-08](#), FINRA sought comment on an initial proposal regarding proposed FINRA Rules 2121 (Fair Prices and Markups, Markdowns and Commissions) and 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities) governing markups, markdowns and commissions (the proposed markup rules), and proposed FINRA Rule 2123 (Charges and Fees for Services Performed) governing fees. The proposed FINRA rules are derived from NASD Rule 2440 (Fair Prices and Commissions), NASD IM-2440-1 (Mark-Up Policy), NASD IM-2440-2 (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities), NASD Rule 2430 (Charges for Services Performed), and Incorporated NYSE Rule 375 (Missing the Market).<sup>4</sup> FINRA received 25 comment letters in response to [Regulatory Notice 11-08](#).<sup>5</sup> FINRA now seeks comments on a revised proposal.



## Differences Between the Initial and Revised Proposals

The significant differences between the initial proposal and the revised proposal are set forth below; however, interested parties should carefully read the proposed rule text for a complete and detailed understanding of the revised proposal.

- ▶ The revised proposal amends proposed FINRA Rule 2121 to:
  - ▶ retain the 5% policy and related concepts from NASD IM-2440-1. In the initial proposal, FINRA proposed to delete the 5% policy and all related statements;
  - ▶ establish a rebuttable presumption that a markup, markdown or commission in excess of 5 percent is unfair and unreasonable;
  - ▶ modify the “relevant factors” that member firms should take into consideration in determining the fairness of a markup, markdown or commission to provide additional guidance and, in some instances, expand the scope of the factor; 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, which has been superseded.<sup>6</sup>
- ▶ 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 as defined in Exchange Act Section 3(a)(42) (excluding U.S. Treasury securities as defined in FINRA Rule 6710(p)).

## Revised Proposal

### A. Fair Prices and Markups, Markdowns and Commissions (Proposed FINRA Rule 2121)

Consistent with the initial proposal, FINRA proposes to consolidate and transfer NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 to the Consolidated FINRA Rulebook as new FINRA Rule 2121. FINRA is proposing minor substantive changes to NASD Rule 2440 and NYSE Rule 375, and significant changes to NASD IM-2440-1.<sup>7</sup> As set forth in the initial proposal, FINRA proposes not to incorporate NYSE Rule Interpretation 375/01, which addresses the execution of an order when a member firm has missed the market, into the proposed markup rules.<sup>8</sup> The revised proposal includes additional substantive amendments to proposed FINRA Rule 2121, which are described in detail below.<sup>9</sup>

#### 1. Fair and Reasonable Markups, Markdowns and Commissions (Proposed FINRA Rule 2121(a))

In general, NASD Rule 2440 requires that securities be sold to or purchased from customers at fair prices and, if a member firm acts as agent, be subject to fair commissions or commission-equivalent charges. Fairness is judged by the facts and circumstances of the particular transaction. NASD Rule 2440 also lists certain circumstances and factors that are relevant in determining a markup, markdown or commission.

Consistent with the initial proposal, FINRA proposes to transfer NASD Rule 2440 as proposed FINRA Rule 2121(a), subject to minor changes, to the Consolidated FINRA Rulebook. Proposed FINRA Rule 2121(a) requires, in any securities transaction, if a member firm acts as principal and buys for the member's account from its customer, or sells from the member's account to its customer, that the member firm must buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances, including 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 member firm acts as agent for the member's customer in any securities transaction, the member firm must not charge its customer more than a fair and reasonable commission, commission-equivalent fee, or service charge, taking into consideration all relevant facts and circumstances, including market conditions with respect to such security at the time of the transaction, 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.

## 2. Retaining the “5% Policy” and Related Concepts (Proposed FINRA Rule 2121(b)(1))

NASD IM-2440-1 addresses the 5% policy. The preamble to NASD IM-2440-1 states that the question of fair markups (or spreads) is one for which there is no definitive answer or single interpretation because a markup that may be considered fair in one transaction could be unfair in another transaction, based on the different circumstances of the two transactions. The preamble also refers to a 1943 survey of the FINRA (then NASD) membership, in which 71 percent of respondents indicated that transactions were executed with markups of 5 percent or less.<sup>10</sup> The Board of Governors then determined that in most transactions, markups of 5 percent or less would fall within the “fair and reasonable” standard and adopted the 5% policy as guidance. In addition, NASD IM-2440-1(a) provides several general considerations, including statements that the 5% policy is a guide and not a rule and that a markup pattern of 5 percent or even less may be considered unfair or unreasonable under the 5% policy.

In the initial proposal, FINRA proposed to delete the 5% policy and to provide “Markup Threshold Guidance” in a separate *Regulatory Notice*, which would set forth quantitative guidance regarding markup, markdown and commission thresholds that, if exceeded, would be subject to additional regulatory scrutiny. A majority of the comments received on the initial proposal opposed the elimination of the 5% policy.<sup>11</sup> These commenters stated that the 5% policy generally has been effective in regulating broker-dealers for over 70 years and eliminating it would reduce investor protection, harm investors, and be interpreted by unscrupulous industry members as an invitation to charge excessive or abusive markups and commissions. These commenters urged FINRA to retain the 5% policy (or a similar quantitative standard) in the proposed markup rules because it helps firms in establishing effective supervisory and compliance procedures and setting upper benchmarks applicable to almost all transactions (e.g., the 5% policy aids compliance personnel in surveillance efforts using automated tools, such as exception reports). The commenters also noted that it protects investors from excessive markups and commissions and assists them in challenging excessive markup and commission charges in arbitration and other proceedings. Several commenters suggested that the 5% policy should be revised to include an alternative quantitative standard if the current policy is outdated.

In light of the concerns raised by the comments on the initial proposal, FINRA proposes to retain the 5% policy as FINRA Rule 2121(b)(1).<sup>12</sup> Proposed FINRA Rule 2121(b)(1) incorporates the general considerations from NASD IM-2440-1(a) that the 5% policy is a guide, not a rule and that a markup pattern of 5 percent or less may be considered unfair or unreasonable under the 5% policy. In addition, proposed FINRA Rule 2121(b)(1) provides that when a member firm charges a markup, markdown or commission in excess of 5 percent, a presumption exists that it is unfair and unreasonable. A member firm may overcome the presumption by demonstrating that the markup, markdown or commission is fair and reasonable based on the relevant factors set forth in proposed FINRA Rule 2121(c),

which is based on NASD IM-2440-1(b). All relevant factors may be considered to determine if a member firm has rebutted the presumption; provided, however, the presumption may not be rebutted based solely on the member firm's disclosure to a customer of the firm's markup, markdown or commission (made in compliance with the revised disclosure requirements in proposed FINRA Rule 2121(c)(5)).

Notwithstanding the revised proposal to retain the 5% policy, FINRA recognizes that 5 percent is significantly higher than the average markup, markdown or commission currently charged by most member firms in customer transactions. Since 1943, advances in information and communication technologies, and member firms' front and back office technologies, have significantly reduced execution costs. As a result, markups, markdowns and commissions also have decreased in many investment products. In addition, customers generally have multiple execution options, and competition among market professionals has driven down the amount of markup, markdown or commission a member firm will charge. Accordingly, although proposed FINRA Rule 2121 would retain the 5% policy, member firms should not view the 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).

### **3. Other General Considerations (Proposed FINRA Rules 2121(b)(2) through (b)(5))**

Consistent with the initial proposal, the revised proposal transfers to FINRA Rule 2121(b) (General Considerations) the general considerations in NASD IM-2440-1(a)(2) and (a)(5) with minor changes. The revised proposal transfers NASD IM-2440-1(a)(3) and (c)(2) with clarifying changes that were not included in the initial proposal.<sup>13</sup>

- ▶ Proposed FINRA Rule 2121(b)(2), based on NASD IM-2440-1(a)(2), provides that a member firm may consider its expenses, but shall not justify markups, markdowns or commissions on the basis of expenses that are excessive.
- ▶ Proposed FINRA Rule 2121(b)(3), based on NASD IM-2440-1(a)(3), provides that the difference between the customer's price (including the markup or markdown) and the prevailing market price is the amount (or percentage) to be considered when determining if a member firm has dealt fairly with its customer in a principal transaction. Unless other bona fide, more credible evidence of the prevailing market price can be evidenced, for a markup, a member firm's own contemporaneous cost is the best indication of the prevailing market price of a security, and for a markdown, a member firm's own contemporaneous proceeds are the best indication of the prevailing market price of a security.
- ▶ Proposed FINRA Rule 2121(b)(4), based on NASD IM-2440-1(c)(2), provides that except in riskless principal trades or nearly contemporaneous trades in which a security is held in a member's inventory very briefly, if a member firm sells a security to a customer

from inventory, the amount of the markup would be determined on the basis of the markup over the bona fide representative current market price, and the profit or loss to the member firm from market appreciation or depreciation before, or after, the date of the transaction with the customer would not ordinarily enter into the determination of the amount or fairness of the markup.

- ▶ Proposed FINRA Rule 2121(b)(5), based on NASD IM-2440-1(a)(5), provides that a determination of the fairness of a markup, markdown or commission must be based on a consideration of all the relevant factors, of which the percentage of markup, markdown or commission is only one.

#### 4. Relevant Factors (Proposed FINRA Rule 2121(c))

In the initial proposal, FINRA proposed to transfer as FINRA Rule 2121(c) (Relevant Factors) the non-exclusive list of seven relevant factors in NASD IM-2440-1(b) that a member firm should take into consideration in determining if a markup, markdown or commission is fair and reasonable. FINRA now proposes minor changes to three of the factors to provide additional guidance and, in some cases, to expand the scope of the factor:

- ▶ In the initial proposal, FINRA Rule 2121(c)(2) (The Availability of the Security in the Market), based on NASD IM-2440-1(b)(2), stated that, in the case of an inactive security, the effort and cost of buying or selling the security, or any other unusual circumstances connected with its acquisition or sale, may be a factor in determining the amount (or percentage) of the markup, markdown or commission. The revised proposal expands this provision to provide that the effort and cost of buying or selling a security may be a factor in determining the amount (or percentage) of a markup, markdown or commission if a 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 unusual circumstances connected with a security's acquisition or sale, *e.g.*, the security is acquired through a foreign intermediary.
- ▶ In the initial proposal, FINRA Rule 2121(c)(4) (The Amount of Money Involved in a Transaction), based on NASD IM-2440-1(b)(4), stated that a transaction that involves a small amount of money may warrant a higher percentage of markup, markdown or commission to cover expenses of handling. The revised proposal adds language to provide that a transaction that involves 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.
- ▶ In the initial proposal, FINRA Rule 2121(c)(5) (Disclosure), based on NASD IM-2440-1(b)(5), stated that where a member discloses the amount of the commission charged in an agency transaction, or the markup or markdown made in a principal transaction, to a customer before the transaction is effected, such disclosure may be considered in determining if a member deals fairly with a customer. The revised proposal clarifies that for disclosure to be considered in determining if a member deals fairly with a

customer, a member firm must disclose the total dollar amount and percentage of the commission charged in an agency transaction, or the total dollar amount and percentage of markup or markdown made in a principal transaction to a customer before the transaction is effected. Consistent with the initial proposal, disclosure itself does not justify a markup, markdown or commission that is unfair or unreasonable in light of all other relevant facts and circumstances surrounding the transaction.

Consistent with the initial proposal, FINRA proposes to transfer to FINRA Rule 2121(c) the following four factors with minor, stylistic changes:

- ▶ NASD IM-2440-1(b)(1) would transfer as proposed FINRA Rule 2121(c)(1) (The Type of Security Involved);
- ▶ NASD IM-2440-1(b)(3) would transfer as proposed FINRA Rule 2121(c)(3) (The Price of the Security);
- ▶ NASD IM-2440-1(b)(6) would transfer as proposed FINRA Rule 2121(c)(6) (The Pattern of Markups); and
- ▶ NASD IM-2440-1(b)(7) would transfer as proposed FINRA 2121(c)(7) (The Nature of the Member's Business).

#### **5. Transactions to Which the Rule is Not Applicable (Proposed FINRA Rule 2121(d))**

Consistent with the initial proposal, FINRA Rule 2121(d) provides that FINRA Rule 2121 is not applicable to: (1) the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price, based on NASD IM-2440-1(d); and (2) a transaction in a non-investment grade debt security with a QIB that meets the conditions set forth in proposed FINRA Rule 2122(b)(9), which is described below.

#### **6. Deletion of the "Proceeds Provision"**

When a customer sells one security and buys a second security at the same time, using the proceeds of the securities position liquidated to pay for the second position, the "proceeds provision" in NASD IM-2440-1(c)(5) requires that both trades be treated as a single transaction for markup, markdown and commission purposes, with the result that the total remuneration for both transactions generally cannot exceed the remuneration amount for a single transaction. Consistent with the initial proposal, FINRA proposes not to incorporate the proceeds provision in NASD IM-2440-1(c)(5) in the proposed markup rules.

FINRA received eight comment letters opposing the elimination of the proceeds provision and two comment letters in favor of eliminating it.<sup>14</sup> The commenters that opposed deleting the proceeds provision stated that the provision prevents member firms from “double dipping,” serves as a deterrent to churning and, if deleted, would encourage unscrupulous broker-dealers to engage in serial transactions to generate maximum commission income. Some of the commenters suggested that FINRA clarify the proceeds provision, or provide guidance, instead of deleting it.

FINRA has carefully considered the comments and continues to believe that the proceeds provision should not be incorporated in the proposed markup rules because it includes a standard that is not susceptible to consistent and fair application.<sup>15</sup> In FINRA’s view, the more practical approach is to determine transaction remuneration on a fair basis for each transaction and to address the commenters’ concerns by continuing to monitor accounts for possible churning and other fraudulent trading, or trading that is in violation of just and equitable principles of trade.

#### **7. Deletion of Initial Proposal Regarding Commission Schedules (Proposed FINRA Rule 2121(e))**

FINRA Rule 2121(e) in the initial proposal added a new requirement to the markup rules regarding transaction-based remuneration. In general, the proposed provision required member firms to establish and make available to retail customers the schedule(s) of standard commission charges for transactions in equity securities with retail customers. Commenters on the initial proposal objected to the new requirement stating, among other things, that the requirement would be duplicative of information currently provided to customers, commissions vary widely by account type, posting commission schedules would set a floor instead of fostering competition, and posting commission schedules would be counter-productive in this era of negotiated commissions.<sup>16</sup> In light of the commenters’ concerns, FINRA proposes to delete the proposed requirement.

#### **8. Notice of “Missing the Market” and Consent to Commission Charge (Proposed FINRA Rule 2121(e))**

In the initial proposal, FINRA proposed to incorporate NYSE Rule 375 as proposed FINRA Rule 2121(f) (Notice of “Missing the Market” and Consent to Commission Charge) with minor changes in the Consolidated FINRA Rulebook. In the revised proposal, the provision is renumbered as proposed FINRA Rule 2121(e) and, consistent with the initial proposal, provides that a member firm that accepts an order for execution as agent and, by reason of neglect to execute the order or otherwise, trades with the customer as principal, shall not charge the customer a commission, without the knowledge and consent of the customer.<sup>17</sup>

## **B. Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities (Proposed FINRA Rule 2122)**

NASD IM-2440-2 addresses: (1) additional standards applicable to the determination of a markup or a markdown in a transaction with a customer in a debt security; (2) the procedures to identify prevailing market price; (3) the role of the dealer's contemporaneous cost in determining prevailing market price; and (4) characteristics of "similar securities" and the role of similar securities in determining a markup or a markdown. In the initial proposal, FINRA proposed to transfer NASD IM-2440-2 to the Consolidated FINRA Rulebook as proposed FINRA Rule 2122 without significant changes.<sup>18</sup> FINRA now proposes to incorporate the following additional amendments.

In proposed FINRA Rule 2122(b)(5) and proposed FINRA Rule 2122(b)(6), based on NASD IM-2440-2(b)(5) and (b)(6), FINRA proposes to clarify several statements in the existing provisions that apply when a dealer looks to alternative measures to determine the prevailing market price of a security that the dealer purchases from, or sells to, a customer.

In the initial proposal, FINRA Rule 2122(b)(9), based on NASD IM-2440-2(b)(9), provided that member firms engaged in customer transactions that meet the following conditions are not subject to the requirements governing markups and markdowns for such transactions: (1) the transaction is effected with a QIB;<sup>19</sup> (2) the transaction involves a non-investment grade debt security;<sup>20</sup> and (3) the dealer has determined, after considering the factors set forth in NASD IM-2310-3 (Suitability Obligations to Institutional Customers), that the QIB has the capacity to evaluate independently the investment risk and, in fact, is exercising independent judgment in deciding to enter into the transaction. The revised proposal updates the third criterion in proposed FINRA Rule 2122(b)(9) to delete references to NASD IM-2310-3, which was rescinded on July 9, 2012, align the criterion with the standards regarding institutional suitability in FINRA Rule 2111(Suitability), which took effect on July 9, 2012,<sup>21</sup> and expand the standards to apply to an authorized agent of a QIB.

Specifically, under the revised proposal, the third criterion requires that a dealer have a reasonable basis to believe that a QIB purchasing or selling a non-investment grade debt security is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities, and the QIB affirmatively must indicate that it is exercising independent judgment in deciding to enter into the transaction. In addition, if a QIB has delegated decision-making authority to an agent, such as an investment adviser or a bond trust department, the factors would be applied to the agent.



### C. Charges and Fees for Services Performed (Proposed FINRA Rule 2123)

NASD Rule 2430 requires that charges and fees for services must be reasonable and not unfairly discriminate among customers, and it applies to all charges and fees for services provided by a member firm that are not related to the execution of a transaction.

In the initial proposal, and as described in more detail in [Regulatory Notice 11-08](#), FINRA proposed to adopt NASD Rule 2430 as FINRA Rule 2123 (Charges and Fees for Services Performed) in the Consolidated FINRA Rulebook with a significant change to require member firms to establish and make available to retail customers their schedule(s) of standard charges and fees for services. The initial proposal defined a retail customer as a customer that does not qualify as an “institutional account” as defined in Rule 4512(c).<sup>22</sup> The revised proposal makes two changes to proposed FINRA Rule 2123.

The revised proposal provides in proposed FINRA Rule 2123(a) additional examples of charges and fees for miscellaneous services performed that are subject to the proposed rule, including charges and fees for setting up a new account, research, customer portfolio analysis, tax advice and calculation of required minimum distribution. In addition, the revised proposal modifies the definition of a “retail customer” in proposed FINRA Rule 2123(b), which requires that disclosures regarding charges and fees be made to retail customers. Under the modified definition, a retail customer would mean a customer that does not qualify as an “institutional account” as defined in Rule 4512(c), except any natural person or any natural person advised by a registered investment adviser.

### D. Application of the Proposed Markup Rules to Transactions in Government Securities (FINRA Rule 0150)

FINRA Rule 0150(c) enumerates the FINRA and NASD rules that apply to transactions in, and business activities relating to, exempted securities, except municipal securities, conducted by member firms. The rule does not include the current markup rules<sup>23</sup> and, in general, cases alleging excessive markups, markdowns or commissions in transactions in exempted securities, other than municipal securities, are brought under FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).<sup>24</sup>

In the revised proposal, FINRA proposes to amend FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities) to extend the proposed markup rules to transactions in government securities (as defined in Exchange Act Section 3(a)(42)), except U.S. Treasury securities (as defined in FINRA Rule 6710(p)).<sup>25</sup> Extension of the proposed markup rules to transactions in government securities is consistent with action contemplated since the SEC’s 1996 Approval Order, approving the application of certain FINRA (then NASD) rules to transactions in exempted securities, other than municipal securities.<sup>26</sup> In addition, FINRA collects extensive information about government securities (*i.e.*, agency debentures and agency asset-backed securities), other than U.S. Treasury securities, in TRACE trade reports, and actively surveils the markets in such securities.

## Market Makers

FINRA notes that proposed FINRA Rules 2121 and 2122 (like the current markup rules) do not address a market maker's allowance, subject to the limitations in regulation, to capture the trading spread between the bid and the ask prices and nothing in proposed FINRA Rules 2121 and 2122 affects that body of law and regulation.

## Endnotes

1. The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice 03/12/08](#) (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
2. 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) (NASD Announces Online Availability of Comments) for more information.
3. 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.
4. NASD Rule 2440, NASD IM-2440-1, and NASD IM-2440-2 govern markups, markdowns and commissions in transactions with customers. Fees or charges that are not transaction-related (e.g., charges for safekeeping or collecting dividends or interest for a customer) are governed by NASD Rule 2430 (Charges for Services Performed). NYSE Rule 375 (Missing the Market) addresses instances where, by reason of neglect to execute the order or otherwise, a member firm takes or supplies for its own account the securities named in the order. The rules are summarized in [Regulatory Notice 11-08](#).
5. The comments received in response to [Regulatory Notice 11-08](#) are available on FINRA's website at [www.finra.org/notices/11-08](http://www.finra.org/notices/11-08).
6. FINRA Rule 2111 took effect on July 9, 2012, and superseded NASD Rule 2310 (Recommendations to Customers (Suitability)), NASD IM-2310-1 (Possible Application of SEC Rules 15g-1 through 15g-9), NASD IM-2310-2 (Fair Dealing with Customers), and NASD IM-2310-3 (Suitability Obligations to Institutional Customers).
7. NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 would be deleted with the adoption of proposed FINRA Rule 2121.

© 2013 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

8. As discussed in more detail in [Regulatory Notice 11-08](#), FINRA would delete NYSE Rule Interpretation 375/01, which provides that a member firm that has “missed the market” should contact the customer, inform the customer of the circumstances and permit the customer to choose one of two ways that the member firm then will use to fill the order.
9. This *Notice* does not address certain amendments discussed in [Regulatory Notice 11-08](#) that are not changing under the revised proposal. For example, consistent with the initial proposal, FINRA proposes several conforming changes to FINRA Rule 2121 to add the term “reasonable” when referring to markups, markdowns and commissions that must be “fair” to incorporate the more widely used phrase “fair and reasonable.”
10. The results are based on the 82 percent of the membership that responded to the survey.
11. *See, e.g.*, Law Office of Scott T. Beall (Beall), Law Office of Steve A. Buchwalter, P.C. (Buchwalter), Churchill Financial, LLC (Churchill), Compliance-by-Proxy (CBP), Cornell Securities Law Clinic (Cornell), Barry D. Estell (Estell), William Gladden (Gladden), Ledbetter & Associates P.A. (Ledbetter), North American Securities Administrators Association (NASAA), Public Investors Arbitration Bar Association (PIABA), Jeffrey R. Sonn, Esq. (Sonn), St. John’s School of Law Clinic (St. John’s), and Wells Fargo Advisors (WFA). Six commenters favored retiring the 5% policy. *See* letters from Securities Industry and Financial Markets Association (SIFMA), Financial Services Institute (FSI), Cambridge Investment Research (Cambridge), JW Korth, Moloney Securities, Inc. (Moloney), and National Planning Holdings, Inc. (NPH). However, three of the commenters, SIFMA, FSI and Cambridge, stated that the 5% policy should not be withdrawn unless FINRA provided to the membership, before or at the same time, the “Markup Threshold Guidance” or similar guidance.
12. In light of the proposal to retain the 5% policy, FINRA does not intend at this time to provide “Markup Threshold Guidance” in a separate *Regulatory Notice*.
13. FINRA Rule 2121(b)(1) through (b)(4) as initially proposed would be renumbered, respectively, as proposed FINRA Rule 2121(b)(2) through (b)(5).
14. *See* letters from Beall, Buchwalter, Cornell, Estell, Gladden, Ledbetter, NASAA, and PIABA opposing the deletion of the proceeds provision. *See* letters from SIFMA and Roberts & Ryan Investments, Inc. (R&R) in favor of deleting the provision.
15. For example, it is not always clear when two transactions occurring close in time are related (the two transactions may represent unrelated investment decisions) or how close in time transactions must be to be considered “proceeds” transactions. In addition, the proceeds provision may not be applied when a customer decides to sell a position at one member firm and purchase a position at another member firm.
16. *See, e.g.*, letters from Cambridge, CBP, Churchill, FSI, Moloney, NPH, Regal Bay Investment Groups, R&R, SIFMA, and WFA opposing the requirement to provide equity commission schedules to retail customers; letter from Juanita D. Hanley noting certain limitations of the proposed requirement; and letters from Cornell, St John’s, NASAA, and Sonn supporting the proposed requirement.

17. Proposed FINRA Rule 2121(e) would be a new requirement for former NASD-only members. As discussed in the initial proposal, FINRA proposes to transfer these requirements because there are no similar requirements in the NASD markup rules regarding whether, and under what circumstances, a member firm may charge a commission if a member “misses the market.”
18. NASD IM-2440-2 would be deleted with the adoption of FINRA Rule 2122.
19. See 17 CFR § 230.144A(a)(1).
20. For the purpose of the rule, the proposal would adopt the definition of “non-investment grade debt security” in NASD IM-2440-2(b)(9) with no change.
21. See *supra* note 6.
22. NASD Rule 2430 would be deleted with the adoption of FINRA Rule 2123. See [Regulatory Notice 11-08](#). See also [Notice to Members 92-11](#) (Fees and Charges for Services).
23. This is largely for historical reasons. The Government Securities Act Amendments of 1993 (GSAA) eliminated the statutory limitations on NASD’s authority to apply sales practice rules to transactions in exempted securities, except municipal securities. NASD undertook to review the specific application of certain of its rules, including the NASD markup rules then in effect (Rules 2440 and IM-2440-1), to the government securities market. See [Notice to Members 96-66](#) (October 1996). NASD IM-2440-2 (the debt markup interpretation) – approved in 2007 – had not been adopted at the time FINRA Rule 0150 (then NASD Rule 0116) went into effect. See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Order Approving File No. SR-NASD-2000-038 (NASD Rule 0116)); see also Securities Exchange Act Release No. 55638 (April 16, 2007), 72 FR 20150 (April 23, 2007) (Order Approving File No. SR-NASD-2003-141 (NASD IM-2440-2)).
24. In [Notice to Members 96-66](#), FINRA noted that actions for conduct generally encompassed by the NASD markup rules, among others, in the government securities market may be brought under FINRA Rule 2010. See also Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39) (1996 Approval Order).
25. “U.S. Treasury security” is defined in FINRA Rule 6710(p) to mean a security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities.
26. See *supra* note 24, the 1996 Approval Order at 61 FR 44104.