

Regulatory Notice

11-08

Markups, Commissions and Fees

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

Comment Period Expires: March 28, 2011

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook)¹ FINRA is requesting comment on the proposed consolidated FINRA rules governing markups, markdowns, commissions and fees.

The text of the proposed rules is available as Attachment A on our website at www.finra.org/notices/11-08.

Questions regarding this *Notice* should be directed to Sharon K. Zackula, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8985.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 28, 2011.

Member firms and other interested parties can submit their comments using 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

February 2011

Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

Suggested Routing

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

Key Topics

- ▶ Markups and Markdowns
- ▶ Commissions
- ▶ Commission Schedule
- ▶ Service Fees and Charges
- ▶ Service Fee Schedule

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ NASD Rule 2430
- ▶ NASD Rule 2440
- ▶ NASD IM-2440-1
- ▶ NASD IM-2440-2
- ▶ NTM 92-11
- ▶ NYSE Rule 375 and Interpretation 375/01
- ▶ Regulatory Notice 08-80
- ▶ SEA Section 19



Financial Industry Regulatory Authority

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

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.³

Background

NASD Rule 2440 (Fair Prices and Commissions), NASD IM-2440-1 (Mark-Up Policy) and NASD IM-2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities)—collectively referred to as the “markup rules”—govern markups, markdowns and commissions in transactions with customers. Charges or fees that are not transaction-related, such as 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) prohibits a member from charging a customer a commission without the customer’s knowledge and consent on an order if the member has accepted the order for execution and, by neglecting to execute the order or otherwise, takes or supplies for its own account the securities named in the order.⁴ NYSE Rule Interpretation 375/01 (Customer Contact and “As of” Reports) states that a member 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 the member will fill the order.

Proposal

As further detailed below, FINRA proposes to transfer NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 to the Consolidated FINRA Rulebook as FINRA Rule 2121 (Fair Prices and Markups, Markdowns and Commissions), subject to significant changes. Among other things, FINRA proposes to eliminate the “5% policy” and the “proceeds provision” in NASD Rule IM-2440-1. FINRA also proposes to require firms to provide commission schedule(s) for equity securities to retail customers, and to notify and obtain consent from a customer to charge a commission when a firm misses the market and trades with the customer on a principal basis.

In addition, FINRA proposes to transfer the requirements set forth in NASD IM-2440-2 to the Consolidated FINRA Rulebook as FINRA Rule 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities), without significant change. FINRA proposes not to incorporate in the Consolidated FINRA Rulebook the substantive provisions of NYSE Rule Interpretation 375/01 (Customer Contact and “As of” Reports), which addresses the execution price of orders where a member has missed the market.

With respect to service charges and fees, FINRA proposes to transfer NASD Rule 2430 to the Consolidated FINRA Rulebook as FINRA Rule 2123 (Charges and Fees for Services Performed). Similar to the proposed commission disclosure requirement, FINRA proposes to require members to provide retail customers with schedule(s) of charges and fees for services.⁵

The most significant proposed changes are described generally below. However, FINRA encourages member firms to carefully review the entire proposed rule text (in Attachment A at www.finra.org/notices/11-08) to understand the full extent of the proposed changes.

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

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

Proposed FINRA Rule 2121(a) incorporates the requirements of NASD Rule 2440 with minor changes.⁶ Generally, NASD Rule 2440 requires that securities be sold to or purchased from customers at fair and reasonable prices and, if firms act as agents, be subject to fair and reasonable commissions or commission-equivalent charges. Fairness is judged by the facts and circumstances of the particular transaction. NASD Rule 2440 also lists a few of the circumstances or factors that are generally relevant in determining a markup (or a markdown); the rule sets forth similar factors to apply when a firm acts as agent and charges a commission.⁷

In the new rule, FINRA proposes to clarify a provision in NASD Rule 2440 regarding a member engaged in a principal transaction, which provides: “he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including... the fact that he is entitled to a profit.” FINRA proposes to amend the provision to state: “the member shall buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances, including... the fact that the member is entitled to remuneration.” While members may set customer transaction remuneration charges that are profitable, the markups, markdowns and commissions charged by a member must be established in line with the considerations set forth in the rule. For example, a member that charges a fixed commission of \$20 per transaction generally would be entitled to charge this same commission for a purchase transaction of 20 shares of a security at an execution price of

\$2. However, a member's right to set profitable transaction charges does not obviate the requirement to comply with the standards of the rule; is not a license to set high minimum markup, markdown or commission charges; and does not allow a member to factor into such charges realized and unrealized market losses on securities that a member holds or has held in inventory.

2. General Considerations; Deletion of the "5% Policy" (Proposed FINRA Rule 2121(b))

FINRA proposes two significant changes to NASD-IM-2440-1 to be transferred to FINRA Rule 2121. First, FINRA proposes not to incorporate the existing "5% Policy" in proposed FINRA Rule 2121(b) (General Considerations).

The "5% Policy" of NASD IM-2440-1 is set forth and discussed in the preamble of NASD IM-2440-1 and referenced in NASD IM-2440-1(a). The preamble 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, which revealed that 71 percent of respondents indicated that transactions were executed with markups of 5 percent or less.⁸ The Board 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.⁹ In addition, NASD IM-2440-1(a) provides several "General Considerations." Two address the "5% Policy," stating that the "5% Policy" is a guide and not a rule (NASD IM-2440-1(a)(1)), and that a markup pattern of 5 percent or even less may be considered unfair or unreasonable under the "5% Policy" (NASD IM-2440-1(a)(4)).

FINRA believes that the "5% Policy"—which is based on the execution practices and market efficiencies of nearly 70 years ago—should not be transferred to proposed FINRA Rule 2121. The "5% Policy" is viewed by many as establishing a presumption that markups, markdowns and commissions in excess of 5 percent are prohibited, or, at best, are subject to additional scrutiny, requiring the firm to provide more justification to prove that such remuneration is not "excessive." Conversely, the "5% Policy" is also viewed by many 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).

Five percent is significantly higher than the average markup, markdown or commission currently charged by most firms in equity transactions. In a recent study conducted by an independent consultant, based on a sample of more than 161,000 equity transactions with customers, the mean markup was 2.2 percent and the average or median markup was 2 percent.¹⁰ Markdowns were even lower: the mean markdown was 1.9 percent and the median markdown was 1.3 percent.¹¹

For debt securities transactions, FINRA also believes that 5 percent is higher than the average markup or markdown charged currently. In this regard, FINRA's preliminary review indicates that debt markups and markdowns in TRACE-Eligible Securities transactions are generally lower than 5 percent.¹² Such markups and markdowns are consistent with the SEC staff's position that debt markups and markdowns generally are expected to be lower than equivalent remuneration in equity transactions.¹³

As the markups, markdowns and commissions that members currently charge in equity and debt transactions are generally lower than 5 percent, FINRA believes the "5% Policy" is outdated and should be deleted. **FINRA emphasizes that the elimination of the "5% Policy" would not be an opportunity to increase markups, markdowns and commissions, but instead reflects FINRA's determination that the "5% Policy" does not reflect current industry practices.** The decision to delete the "5% Policy" also reflects FINRA's view that competition, market pricing efficiency and automation generally have reduced markups, markdowns and commissions materially below 5 percent, and rather than base remuneration for transaction executions off an outdated metric from 1943, a member must use the factors in proposed FINRA Rule 2121(c) to rationalize its remuneration for the execution of a transaction.

At this time, FINRA also does not propose a new policy based upon a lower percentage as this may encourage members to artificially peg (or cap) their markups, markdowns and commissions based upon the new percentage,¹⁴ instead of using the factors in the rule to rationalize their remuneration for the execution of transactions.

With the deletion of the "5% Policy," proposed FINRA Rule 2121(b) is based upon three "General Considerations" from NASD IM-2440-1(a) and an additional provision regarding sales from inventory previously located in NASD IM-2440-1(c)(2). More specifically, FINRA proposes to transfer:¹⁵

- ▶ NASD IM-2440-1(a)(2) regarding excessive expenses as proposed FINRA Rule 2121(b)(1), and to amend the provision to reference explicitly markdowns and commissions.
- ▶ NASD IM-2440-1(a)(3) as proposed FINRA Rule 2121(b)(2), subject to certain amendments to clarify the presumption that the member's own contemporaneous cost is the best indication of the prevailing market price, unless other bona fide, more credible evidence of the prevailing market price can be evidenced. Currently, NASD IM-2440-1(a)(3) provides: "In the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security." In contrast, proposed FINRA Rule 2121(b)(2) provides: "For a markup, a member's own contemporaneous cost is the best indication of the prevailing market price of a security, and for a markdown, a member's own contemporaneous proceeds are the best indication of the prevailing market price of a security, unless other bona fide, more credible evidence of the prevailing market price can be evidenced."

- ▶ NASD IM-2440-1(c)(2), regarding sales from or to inventory, as proposed FINRA Rule 2121(b)(3). The provision provides that in a principal transaction, when a member sells a security from inventory to a customer, the amount of profit or loss to the member 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 dealer's markup. FINRA proposes to amend this provision to apply explicitly to markdowns in the case where the member purchases a security into inventory from a customer.
- ▶ NASD IM-2440-1(a)(5), which provides that determination of the fairness of a markup must be based on a consideration of all the relevant factors, of which the percentage of markup is only one, as FINRA Rule 2121(b)(4). FINRA proposes to amend the provision to reference explicitly markdowns and commissions.

3. Deletion of the "Proceeds Provision"

In addition to the elimination of the "5% Policy," the second significant change to the consolidation and transfer of IM-2440-1 to FINRA Rule 2121 is the elimination of the "proceeds provision" (NASD IM-2440-1(c)(5)). Currently, 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" requires that both trades be treated as a single transaction for markup, markdown or commission purposes. Consequently, the total remuneration for both transactions would generally not be allowed to exceed the remuneration amount for a single transaction. FINRA proposes to eliminate it because the provision is confusing and raises concerns that it represents a standard that may not be susceptible to consistent application. 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. Further, the "proceeds provision" cannot be applied where a customer decides to sell a position at one broker-dealer to purchase a position at another broker-dealer. FINRA believes the more rational approach is that transaction remuneration be determined on a fair basis pertaining to each transaction.

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

FINRA proposes to transfer to FINRA Rule 2121(c) (Relevant Factors) the non-exclusive list of seven relevant factors that a member should take into consideration in determining if a markup, markdown or commission is fair and reasonable. The factors are:

- (1) type of security involved;
- (2) availability of the security in the market;
- (3) price of the security;
- (4) amount of money involved in a transaction;

- (5) disclosure;
- (6) pattern of markups; and
- (7) nature of the firm's business.

Also, the transferred provisions incorporate minor stylistic changes to delete certain outdated language.

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

Proposed FINRA Rule 2121(d) includes, with minor, non-substantive amendments, the provision that the markup rule (formerly "policy") does not apply to the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price (NASD IM-2440-1(d)). Also, proposed FINRA Rule 2121(d) is updated to reflect that FINRA Rule 2121 does not apply to a transaction with a qualified institutional buyer (QIB) that meets the conditions of proposed FINRA Rule 2122(b)(9) (current NASD IM-2440-2(b)(9)).

6. Commission Schedules (Proposed FINRA Rule 2121(e))

In proposed FINRA Rule 2121(e), FINRA proposes an additional requirement regarding transaction-based remuneration. The proposed rule requires a member to establish and make available to retail customers the schedule(s) of standard commission charges for transactions in equity securities with retail customers.¹⁶ A member would be allowed to establish and publish multiple schedules of standard commission charges, as long as it discloses in or with the schedule(s) how the commissions are stratified among all retail customers.

In addition, the prior disclosure of commissions for equity securities transactions would not preclude a member from negotiating lower commission rates with retail customers, provided that the member discloses, in or with the schedule(s), that the member may do so from time to time. A member would be required to provide in writing (which may be electronic) the schedule(s) of commissions to new retail customers at the opening of an account, and all retail customers at least once every calendar year. In addition, a member would be required to provide in writing (which may be electronic) any amendments to the schedule(s) of commissions (including any new forms of commissions or new disclosures) to all retail customers at least 30 days prior to imposing any change in the commissions set forth in the schedules or any new forms of commission charges for retail customers.

Alternatively, a member would be permitted to make available to retail customers its schedule(s) of standard commission charges applicable to retail customers by posting them on its website if the member provides written notice (which may be electronic) to new retail customers at the opening of an account, and all retail customers at least once every calendar year, of the manner in which they may access the commission schedules, and

that, upon a retail customer's request, the member will provide a copy of the commission schedules to the customer. In such case, a member also would be required to provide written notice (which may be electronic) to all retail customers at least 30 days prior to imposing any change in the commissions set forth in the schedules or any new forms of commission charges for retail customers.

The proposed requirement is limited to commissions on equity securities because such commissions are most easily compared by retail customers and more readily reduced to fixed amount or ranges than are commissions applicable to other securities transactions, such as debt, or negotiated by institutional accounts. FINRA anticipates that a retail customer's ability to compare equity commissions among members may, by competition, result in lower commissions (and markups and markdowns).

7. Notice of "Missing the Market" and Consent to Commission Charge (Proposed FINRA Rule 2121(f))

FINRA proposes to incorporate the substantive requirements of NYSE Rule 375 in proposed FINRA Rule 2121(f). NYSE Rule 375 prohibits a member from charging a commission without the customer's knowledge and consent on an order if the member has accepted the order for execution and, by reason of neglect to execute the order or otherwise, takes or supplies for its own account the securities named in the order. FINRA proposes to transfer these requirements to proposed FINRA Rule 2121 because there are no similar requirements in the NASD markup rules regarding whether, and under what circumstances, a member may charge a commission if a member "misses the market." Proposed FINRA Rule 2121(f) would be a new requirement for former NASD-only members.

8. Other Provisions Transferring With Minor Changes or to be Deleted (Paragraphs (a), (b) and (d) of Proposed FINRA Rule 2121)

FINRA also proposes the following minor amendments and deletions as part of the transfer and consolidation of NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 into FINRA Rule 2121:

- ▶ FINRA proposes deleting (in addition to the "proceeds provision" in IM-2440-1(c) as discussed above) the remaining provisions in NASD IM-2440-1(c) because they are redundant or readily implied in other provisions to be incorporated in FINRA Rule 2121. Specifically, the following provisions would not be transferred to FINRA Rule 2121:
 - ▶ IM-2440-1(c)(1), stating that "riskless" transactions are subject to the markup rules;
 - ▶ IM-2440-1(c)(3), providing that member purchases from customers are subject to the markup rules and the price paid to the customer or the markdown applied by the member must be reasonably related to the prevailing market price of the security; and

- ▶ IM-2440-1(c)(4), stating that transactions where the member acts as agent are subject to the markup rules and a commission charged a customer must be fair in light of all relevant circumstances.
- ▶ FINRA also 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.”
- ▶ The proposed amendments include additional non-substantive, technical changes to FINRA Rule 2121 not specifically referenced above to modify outdated language; to clarify that generally the provisions of FINRA Rule 2121 refer to markups, markdowns and commissions; and to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

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

FINRA proposes to transfer NASD IM-2440-2 to the Consolidated FINRA Rulebook as FINRA Rule 2122 without significant changes.¹⁷ Proposed FINRA Rule 2122 contains:

- ▶ the standards for determining a markup or a markdown in a transaction with a customer in a debt security (except a municipal security);
- ▶ the procedures to identify prevailing market price;
- ▶ the role of the dealer’s contemporaneous cost in determining prevailing market price;
- ▶ the characteristics of “similar securities”; and
- ▶ the role of similar securities in determining a markup or a markdown that are currently set forth in NASD IM-2440-2.

The proposed rule also includes an exemption from the requirements of proposed FINRA Rule 2121 and FINRA Rule 2122 for certain transactions in non-investment grade securities effected with certain QIBs that is currently in NASD IM-2440-2(b)(9). In addition, proposed FINRA Rule 2122 includes minor changes to update rule cross-references and to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

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

FINRA proposes to transfer NASD Rule 2430, with a significant change, to the Consolidated FINRA Rulebook as FINRA Rule 2123.¹⁸ Proposed FINRA Rule 2123(a) restates the current requirement that charges and fees for services must be reasonable and not unfairly discriminate among customers and, like NASD Rule 2430, applies to all charges and fees for services provided by a member that are not related to the execution of a transaction.

Similar to the proposed commission disclosure requirement discussed above, FINRA

proposes to require a member to establish and make available to retail customers a member's schedule(s) of standard charges and fees for services for retail customers (proposed FINRA Rule 2123(b)).¹⁹ A member that establishes and publishes more than one schedule of standard charges and fees for services for retail customers would be required to disclose, in or with the schedule(s), the manner in which such schedules apply to various types or classes of retail customers, accounts or services. Also, a member would not be precluded from negotiating lower charges and fees with retail customers, provided that the member discloses, in or with the schedule(s), that it may do so from time to time. A member would be required to provide in writing (which may be electronic) the schedule(s) of standard charges and fees for services to new retail customers at the opening of an account, and all retail customers at least once every calendar year. In addition, a member would be required to provide in writing (which may be electronic) any amendments to the schedule(s) of standard charges and fees for services (including any new charges or fees) to all retail customers at least 30 days prior to imposing any change in the charges and fees or disclosures set forth in the schedule(s) or any new charges or fees for retail customers.

Alternatively, a member would be permitted to make available to retail customers the member's schedule(s) of standard charges and fees for services by posting them on its website if it provides written notice (which may be electronic) to new retail customers at the opening of any account, and all retail customers at least once every calendar year, of the schedule(s) and the manner in which they may be accessed. Upon a retail customer's request, the member would provide a copy of the schedule(s) of standard charges and fees to the customer. In such case, a member also would be required to provide written notice (which may be electronic) to all retail customers at least 30 days prior to imposing any change in the charges and fees or disclosures set forth in the schedule(s) or any new charges or fees for retail customers.²⁰

Proposed FINRA Rule 2123(a) also includes additional non-substantive, technical changes to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

D. NYSE Provision Proposed for Deletion (NYSE Rule Interpretation 375/01)

FINRA proposes not to incorporate NYSE Rule Interpretation 375/01 in the Consolidated FINRA Rulebook, relating to the execution price of orders where a member has missed the market. A member's existing obligations under NASD Rule 2320,²¹ which broadly requires that a member execute a customer order in the best market for that security "so that the resultant price to the customer is as favorable as possible under prevailing market conditions," and NASD Rule 2111, which requires a member to "make every effort to execute a customer market order that it receives fully and promptly," adequately address such situations.²²

E. Market Makers

Proposed FINRA Rule 2121 and proposed FINRA Rule 2122, as is the case with 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. Nothing in the proposed markup rules 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).
- 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 (NTM) 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily temporarily suspend these types of rule changes within 60 days of filing. If the SEC takes such action, the SEC shall institute proceedings to determine whether the proposed rule should be approved or disapproved. See SEA Section 19 and rules thereunder.
- 4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 5 NASD Rules 2440 and 2430, NASD IMs 2440-1 and 2440-2, and NYSE Rule 375 would be deleted in their entirety from the Transitional Rulebook with the adoption of FINRA Rules 2121, 2122 and 2123. NYSE Rule Interpretation 375/01 (Customer Contact and "As of" Reports) would not be transferred to the Consolidated FINRA Rulebook and would be deleted in its entirety from the Transitional Rulebook.
- 6 There is no NYSE rule equivalent to NASD Rule 2440 or to NASD IM-2440-1.
- 7 Additional factors that are generally relevant in determining a markup, markdown or commission are set forth in NASD IM-2440-1.
- 8 Although the entire membership was surveyed, 82 percent of the membership responded.
- 9 The preamble also states that a firm violates NASD Rule 2110 (now FINRA Rule 2010) and NASD Rule 2440 if it enters into any transaction with a customer at any price not reasonably related to the current market price of the security or charges a commission that is not reasonable.

- 10 Ferrell, A., *The Law and Finance of Broker-Dealer Mark-Ups* (Ferrell Study). The Ferrell Study was conducted at FINRA's request, and is based on more than 161,000 equity transactions. The data is a sample largely consisting of lower-priced, less liquid securities (the median price of stock purchased by customers was \$5.50), which were purchased or sold over-the-counter to retail customers. (Approximately 98 percent of the transactions were executed over-the-counter.) FINRA collected the data from 14 broker-dealers that had certain compliance issues in their records, tended to be small to medium-sized firms and tended to deal primarily with retail customers. Most of the transaction data was collected as part of a FINRA sweep examination conducted in 2004 of the firms, which preceded the study and was not done for purposes of the study. The Ferrell Study uses the term "markup" (or "markdown") to also include agency remuneration (commissions).
- 11 To compare some of the recent transaction data with the 1943 markup data, Ferrell also identified markup levels at the 71st percentile and the 47th percentile. Ferrell found that markups in recent transactions at the 71st percentile were 2.95 percent (compared to 5 percent in 1943) and markups in the 47th percentile were 1.8 percent (compared to 3 percent in 1943).
- 12 FINRA has commenced, but has not yet completed, a review of transactions in TRACE-Eligible Securities (as defined in FINRA Rule 6710) executed during the first two quarters of 2008 to determine the median and mean markups and markdowns currently charged in such debt securities transactions. (Very few transactions in TRACE-Eligible Securities are executed in an agency capacity.)
- 13 The SEC staff made a similar statement in 1987. *Zero Coupon Securities*, Exchange Act Release No. 24368 (April 21, 1987), 52 FR 15575 (April 29, 1987).
- 14 In lieu of stating in proposed FINRA Rule 2121 that a markup, markdown or commission of less than a specified amount or percentage, such as 3 percent or 3.5 percent, may not be excessive, FINRA expects to provide guidance in a *Regulatory Notice* that markups, markdowns and commissions above certain specified percentages will be subject to additional regulatory scrutiny, requiring members to provide additional justification to establish that such markups, markdowns, and commissions are not excessive.
- 15 NASD IM-2440-1(a)(1) and NASD IM-2440-1(a)(4) are based upon the "5% Policy" and, as discussed above, would not be transferred to proposed FINRA Rule 2121.
- 16 For purposes of the requirement, the term "retail customer" means a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). The SEC recently approved the adoption of NASD Rule 3110(c)(4) as FINRA Rule 4512(c) without material change. See Exchange Act Release No. 63784 (January 27, 2011), 76 FR 5850 (February 2, 2011) (Order Approving File No. SR-FINRA-2010-052). FINRA will announce the effective date of FINRA Rule 4512 in a *Regulatory Notice*.
- 17 There is no NYSE rule equivalent to NASD IM-2440-2.
- 18 There is no NYSE rule equivalent to NASD Rule 2430.

- 19 For purposes of the requirement, the term “retail customer” means a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). The SEC recently approved the adoption of NASD Rule 3110(c)(4) as FINRA Rule 4512(c) without material change. *See supra* note 16.
- 20 The requirement to disclose a member’s fees and charges to new retail customers and to notify all retail customers of changes to existing fees or new fees at least 30 days prior to imposing the changes in the fees or the new fees is based on current guidance. *See NTM 92-11* (February 1992).
- 21 FINRA has proposed to adopt new FINRA Rule 5310 (Best Execution and Interpositioning), based largely on NASD Rule 2320. *See Regulatory Notice 08-80* (December 2008).
- 22 FINRA has proposed to adopt NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) with significant changes as new FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders). *See* Exchange Act Release No. 61168 (December 15, 2009), 74 FR 68084 (December 22, 2009) (Notice of Filing SR-FINRA-2009-090).