Regulatory Notice 15-36

Pricing Disclosure in the Fixed Income Markets

FINRA Requests Comment on a Revised Proposal Requiring Confirmation Disclosure of Pricing Information in Corporate and Agency Debt Securities Transactions

Comment Period Expires: December 11, 2015

Executive Summary

FINRA is requesting comment on a proposed rule that would require member firms to disclose additional information on customer confirmations for transactions in corporate and agency debt securities. FINRA initially sought comment on the proposed rule in *Regulatory Notice 14-52*. In response to the comments received, FINRA is proposing several changes to the proposed rule. These changes include replacing the size-based disclosure threshold with a retail customer standard; permitting firms to use alternate methodologies for calculating the reference price for more complex trade scenarios; requiring firms to add a link to TRACE on the confirmation; and proposing additional exceptions from the requirements.

FINRA and the Municipal Securities Rulemaking Board (MSRB) have discussed a coordinated approach to potential rulemaking in this area. The MSRB has published *Regulatory Notice 2015-16* soliciting comment on a revised proposal that differs from FINRA's proposal described herein. This *Notice* also invites comment on the MSRB's revised approach.

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

Questions concerning this *Notice* should be directed to:

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

FINRA

Financial Industry Regulatory Authority

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Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Trading

Key Topics

- Fixed Income Securities
- Pricing Information
- Transaction Confirmations

Referenced Rules & Notices

- FINRA Rule 2232
- MSRB Regulatory Notice 2014-20
- MSRB Regulatory Notice 2015-16
- Regulatory Notice 14-52
- SEA Rule 10b-10

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by December 11, 2015.

Comments must be submitted through one of the following methods:

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

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

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

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

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

Background and Discussion

Initial Proposal

In *Regulatory Notice 14-52*, FINRA sought comment on a proposal to require firms to disclose additional pricing information for retail-size customer trades in corporate and agency debt securities.[3] Specifically, the proposal would require that, if a firm sells to a customer as principal and on the same day buys the same security as principal from another party, the firm would have to disclose on the customer confirmation (i) the price to the customer; (ii) the price to the firm of the same-day trade (reference price); and (iii) the difference between those two prices.[4] Under the initial proposal, the disclosure requirement would apply where the transaction with the customer was of a "qualifying size" of 100 bonds or less or bonds with a face value of $100,000 or less, which was designed to capture those trades that are retail in nature.

Revised Proposal in Response to Comments

FINRA received 30 comment letters in response to its initial proposal.[5] FINRA now seeks comments on a revised proposal. The significant differences between the initial proposal and the revised proposal include:

- replacing the "qualifying size" threshold with a retail customer account standard;
- permitting firms to use alternative methodologies for calculating the reference price for more complex trade scenarios;
- permitting firms, in the event of a material change in the price of the security between the time of the firm principal trade and the customer trade, to omit the reference price;
- requiring a link to TRACE data on confirmations that are subject to the disclosure requirement;
- providing an exemption to the proposed disclosure requirements for transactions that are part of a fixed price new issue and are sold at the fixed price offering price;
- excluding firm principal trades that are executed on a trading desk functionally separate from the retail trading desk for purposes of calculating a reference price; and
- excluding firm principal trades with affiliates for positions that were acquired by the affiliate on a previous trading day.

A. Criteria For Triggering Disclosure

In the initial proposal, FINRA proposed that the disclosure requirement would apply where the transaction with the customer was of a "qualifying size" of 100 bonds or less or bonds with a face value of $100,000 or less. This qualifying size standard was designed to capture those trades that are retail in nature. Commenters indicated that the 100-bond standard may be difficult to implement, whereas a retail/institutional account identification is already used in firms' business processing and therefore would be simpler to apply. Accordingly, FINRA proposes to replace the qualifying size requirement with an exclusion for transactions that involve an institutional account, as defined in FINRA Rule 4512(c).[6] This would ensure that all eligible transactions involving non-institutional customer accounts, regardless of size or face amount, would be subject to the proposed disclosure.

B. Alternative Methodologies for More Complex Trades

The initial proposal set forth several methodologies that firms should apply when there are multiple firm trades equaling or exceeding a customer trade, which could potentially contribute to the determination of the reference price for purposes of the proposed disclosure. These methodologies consisted of average weighted price, last in, first out, and closest in time. Commenters raised concerns about the operational burdens associated with determining the reference price for these "complex" trade scenarios and said that determining the reference price would be difficult and costly.[7] Commenters also indicated

that differing methodologies would result in inconsistent disclosures for similar customer trades on the same trading day. In response to these comments, FINRA is proposing to provide flexibility to establish alternative methodologies in certain instances.

In non-complex scenarios, where there is a non-institutional customer transaction and a firm principal transaction of the same or greater size without intervening principal trades within the same trading day, determining the reference price to include on the confirmation is straightforward. FINRA therefore is proposing that the price of the principal trade should be used as the reference price for these scenarios.[8]

However, where there is not a same (or greater) size principal and customer trade scenario or there are one or more intervening principal trades of a different size, the proposal would allow firms flexibility in calculating the reference price.[9] In such scenarios, firms may employ a reasonable alternative methodology, such as the average weighted price of the firm trades that equal or exceed the size of the customer trade, or the price of the last same-day trade executed as principal by the firm prior to the customer trade (or closest in time if executed after), irrespective of the size of that principal trade.[10] The firm must adequately document and consistently apply its chosen methodology.[11]

Attached as Attachment B is a more detailed description of the guidelines firms must follow when establishing a reference price with specific examples.

C. Material Changes to the Price of the Security

Some commenters also raised concerns about scenarios where there is a material change in the market price, due to, for example, a credit downgrade or breaking news regarding the obligor. These commenters indicated that customers may be confused by reference price information provided on trading days where there are large price swings between the time of the trade with the customer and the firm's own trade. These scenarios do not necessarily involve operational difficulties in calculating the reference price; rather, firms are concerned the reference price may be confusing or misleading.[12]

In response to these comments, the proposal would permit firms to either not disclose the reference price, or disclose with the reference price clarifying information, where the firm can demonstrate that there was an unusual and material change in the price of the bond between the time of the firm principal and the customer transactions. This provision is not intended to be used when the price of the security has changed due to normal price fluctuations or general market volatility. Firms may use this provision when the material change in the price of the security has occurred due to a material event such as a credit downgrade or breaking news. A firm that elected not to disclose the reference price under this provision would be required to demonstrate that there was a material change in the price of the security between the time of the firm and the customer transactions.

D. Link to TRACE Data

Several commenters advocated replacing this proposal with a variety of methods of providing TRACE data to customers. However, FINRA believes that access to TRACE data alone is insufficient because an investor may not be able to use TRACE to identify precisely the principal trade that was made by that investor's broker-dealer, and thus would not be able to ascertain the exact amount of the price differential between the firm and customer trade. FINRA agrees that TRACE data can help customers understand the market at the time of the customer's transaction, and that investors should be encouraged to access this information. FINRA is therefore proposing that firms also be required to provide a link to TRACE on the customer confirmation. FINRA also invites comment on other ways, in addition to the proposed requirement that firms include a link to TRACE on the confirmation, in which it could make TRACE data more accessible to investors.

E. Fixed Price New Issues

Some commenters indicated that new issues should be exempted from the proposal, as primary offerings already provide significant disclosure through offering memoranda. In response, FINRA proposes to exclude transactions that are part of fixed price offerings and are sold at the fixed price offering price on their first trading day from the proposed disclosure. However, in contrast, variable price offerings are reported as secondary trades, may involve investors paying different prices, and may be difficult for firms to distinguish from other kinds of secondary trades. Therefore, the revised proposal would continue to apply the proposed disclosure requirements to transactions that are part of variable price offerings.

F. Trades That Occur on Functionally Separate Desks

The initial proposal required disclosure if a firm principal trade occurred on the same day as a customer trade of Qualifying Size and did not distinguish between where the firm principal trade originated within the firm for purposes of triggering the disclosure requirements. Some commenters noted that having the disclosure requirements triggered by trades that were made by separate trading departments or desks would undermine the legal and operational separation of those desks, and may not be relevant in determining the reference price. In response to comments, FINRA proposes to exclude firm-side transactions from the proposed disclosure that are conducted by a department or desk that is functionally separate from the retail-side desk, *e.g.*, where the firm can demonstrate through policies and procedures that the firm-side transaction was made by an institutional desk for an institutional customer that is separate from the retail desk and the retail customer. This exception would not apply, however, where the transaction of the separate department or desk is related to the other desk, *e.g.*, if the transactions and positions of a separate department or desk are regularly used to source the retail transactions at the other desk.

G. Positions Acquired by an Affiliate on a Previous Trading Day

As discussed above, the initial proposal did not distinguish between the types of firm principal trades that would trigger disclosure. Some commenters indicated that a broker-dealer affiliate may hold securities in inventory with any subsequent trades between affiliates being more akin to a back-office transfer. In those situations, commenters indicated that the original acquisition time period of the securities should be used to determine whether the disclosure requirements are triggered. In response to this comment, FINRA proposes to exclude trades where the member's principal trade was executed with an affiliate of the member and the affiliate's position that satisfied this trade was not acquired on the same trading day.

MSRB Proposal

As noted above, the MSRB also published a notice soliciting comment on a revised proposal.[13] As described in detail in the MSRB's notice, the MSRB's approach differs from FINRA's proposed approach described above and would require disclosure of the amount of the firm's mark-up (or mark-down) for certain retail customer transactions, rather than the reference price paid by the firm and the differential between the reference price and the price paid by the customer. Under the MSRB's proposal, the firm would be required to disclose its mark-up or mark-down from the prevailing market price of a security if the firm traded as principal with a non-institutional customer within a discrete time window (*e.g.*, the firm purchased the security in the two hours preceding the sale to the customer, or sold the security in the two hours following the purchase from the customer). [14] While FINRA and the MSRB's revised proposals currently differ, both entities favor a coordinated approach. Accordingly, FINRA is inviting comments on the MSRB's proposal in comparison to FINRA's revised proposal, and whether the MSRB's proposal, or elements of the proposal, may be an appropriate alternative to FINRA's revised proposal.

Economic Impact Analysis

Need for the Rule

FINRA is concerned that investors in fixed income securities currently are limited in their ability to understand and compare transaction costs associated with their purchases and sales. FINRA's analysis of TRACE data for the first quarter of 2015 finds a material difference between the median mark-up/mark-down and the tail of the distribution, indicating that some customers paid considerably more than others in similar trades.

Economic Baseline

The revised proposal would impact broker-dealers in the retail market of corporate and agency debt securities by imposing confirmation disclosure requirements on certain customer transactions. FINRA has analyzed TRACE data for the first quarter of 2015 to better understand the transactions and firms affected by the proposal. Since TRACE data cannot differentiate between retail and institutional transactions, the staff focused on customer trades of 100 bonds or less, which is intended to capture those trades that are retail in nature.[15]

In the first quarter of 2015, the average daily number of retail-sized customer trades (100 or fewer bonds) was 20,510 in corporate debt securities and 768 in agency debt securities. More than half of the corporate bond transactions were in investment grade securities. For both corporate and agency debt securities, approximately 75 percent of the retail-sized customer trades in the first quarter of 2015 were less than 40 bonds. The transactions of interest were also concentrated among large firms. For example, the top 20 broker-dealers with the highest volumes accounted for roughly 70 percent of the transactions for both corporate and agency debt securities.[16]

FINRA also estimated mark-ups and mark-downs on customer trades in corporate and agency debt securities during the first quarter of 2015.[17] This analysis shows that there was a material difference between the median mark-ups and mark-downs and the tail of the distribution. For example, for retail-sized investment grade corporate debt transactions the median estimated mark-up on customer buy orders was 0.51 percent whereas the 95th percentile was more than four times higher (2.22 percent), suggesting that while the mark-up was half a percent or less on 50 percent of these orders, 5 percent of the orders had mark-ups of more than two percent.[18] These results indicate that some customers paid considerably more than others in similar trades.[19] These differences were also significant for high-yield and unrated securities. For example, the median retail-sized corporate debt transactions in high-yield and unrated securities was 0.71 percent and the 95th percentile was 2.68 percent.[20]

FINRA also examined the time period separating the customer trades and the corresponding principal trades during the first quarter of 2015. This analysis reveals that approximately 93 percent of retail-sized customer trades in corporate debt securities with same-sized corresponding principal trades occurred within 10 minutes. Similarly, customer and principal trades occurred within 30 minutes of each other for approximately 96 percent and within 2 hours for more than 98 percent of the trades.[21] For trades involving two or more different sized offsetting transactions, the maximum time interval separating the trades was within 10 minutes for approximately 58 percent, and within 2 hours for 82 percent of the trades.

Economic Impact

As discussed above, the proposal would impact broker-dealers in the retail segment of the corporate and agency debt securities market. To assess the economic impacts associated with the proposed rule change, FINRA reviewed retail-sized customer trades (100 bonds or less) during the first quarter of 2015 to analyze trades that would trigger the disclosure requirement.[22] During this period, there were a total of 826,965 customer trades in corporate debt securities. FINRA estimates that 481,726 (or 58.25 percent) of these trades would be subject to the disclosure requirement. These disclosure-eligible trades were reported by over 800 dealers but were concentrated among large dealers. For example, consistent with the estimates based on all retail-sized customer trades discussed above, the top 20 broker-dealers with the highest number of disclosure eligible retail-sized customer trades accounted for more than 66 percent of these transactions in corporate debt securities.[23] The top 5 dealers alone accounted for more than 36 percent of the corporate debt transactions.

FINRA also examined the trades that would fall under the complex and non-complex trading scenarios discussed in this proposal. As discussed above, non-complex scenarios comprised a customer transaction and a firm principal transaction of the same or greater size without intervening trades within the same trading day. FINRA estimates that at least 76 percent of the disclosure-eligible customer trades in corporate and agency debt securities had corresponding principal trades without intervening trades. In such non-complex scenarios, dealers would be required to disclose the price of the corresponding principal trade as the reference price on the confirmation disclosures. FINRA also estimated the differential between the prices on the customer trades and the corresponding reference prices on principal trades for these non-complex trades. The average price differential in corporate debt securities was 0.73 percent and in agency debt securities was 0.43 percent.[24] Consistent with the mark-up and mark-down analysis discussed above, there was a material difference between the median price differential and the tail of the distribution, which suggests that some customers paid considerably more than others in similar trades. For example, for retail-sized corporate debt transactions the median estimated price differential was 0.48 percent whereas the 95th percentile was much higher at 2.19 percent.[25] These non-complex corporate debt trades were reported by 806 dealers but were concentrated among a few large dealers. For example, the top 20 dealers based on number of disclosure eligible trades accounted for approximately 67 percent of the transactions in corporate debt securities.

FINRA estimates that for approximately 24 percent of the customer transactions in corporate debt securities that would be subject to the disclosure requirement, there were one or more intervening trades of different size. As discussed above, in these complex trading scenarios firms would have flexibility in calculating the reference price. Firms may use a reasonable methodology, such as the average weighted price of the firm trades that equal or exceed the size of the customer trade or the price of the last same-day trade

executed as principal by the firm prior to the customer trade (or closest in time if executed after). FINRA estimates that the average price differential between the prices on the customer trades and the corresponding reference prices for these complex trades was 1.06 percent in corporate debt securities and 0.34 percent in agency debt securities.[26] As with non-complex trading scenarios, there was a material difference between the median price differential and the tail of the distribution for these complex trades as well.[27] Similarly, while the complex trades in corporate debt securities were reported by 443 dealers, they were concentrated among large dealers, with the top 20 broker-dealers (based on number of disclosure eligible trades) accounting for approximately 64 percent of the eligible corporate debt transactions.[28]

Benefits

As with the initial proposal, FINRA believes this additional pricing information will better enable customers to evaluate the cost and quality of the services firms provide by assisting customers in monitoring current same-day prices a firm and a customer pays or receives in connection with a transaction. The proposal will provide customers with pricing information that customers cannot currently obtain through TRACE data. FINRA further believes this type of information will promote transparency into firms' pricing practices and encourage communications between firms and their customers about pricing of their fixed income transactions. This proposal also may provide customers with additional information that may assist them in detecting practices that are possibly improper, which would supplement FINRA's own surveillance and enforcement program.[29] By providing additional pricing information to customers, this proposal may encourage customers to seek out other dealers that might offer more competitive prices. Accordingly, dealers may be incentivized to offer more competitive prices to their retail customers. Any resulting reduction in the differential between the reference price and the price paid by the customer would reduce transaction costs paid by investors and enhance investor confidence. Increase in investor confidence may also encourage wider participation by investors in the retail segments of the corporate and agency debt market.

Costs

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

reprogram. Accordingly, firms would likely incur costs associated with updating operational systems and procedures to identify customer transactions that would be subject to disclosure, costs associated with conveying the disclosure on the customer confirmation, cost of including a link to TRACE on the customer confirmation, and costs associated with adopting policies and procedures to ensure continued compliance with this proposal. FINRA specifically requests comments on the sources and quantified estimates of these costs and will estimate these costs based on the information obtained through the public comment process.

FINRA understands that some firms generate confirmation statements directly following trade execution while others generate confirmations in batches at the end of the day. The costs associated with this proposal may be different depending on the processes that firms rely upon to generate confirmations. FINRA specifically seeks comment on the types of processes firms use to generate confirmations and how the proposal might have differential impacts based on these processes. FINRA requests data and quantified comments where possible.

However, FINRA believes that changing the scope of the proposal to require disclosure for non-institutional accounts may lessen some of the costs and complexity associated with this proposal by allowing firms to use an existing distinction that already is integrated into their operations. Similarly, FINRA believes that providing flexibility to use an alternative methodology for more complex trading scenarios also will lessen the costs and burdens on firms. FINRA does not believe that requiring firms to add a link to TRACE on the customer confirmation will create a significant business or operational impact for firms, but requests comment on the potential impact.

While permitting firms to use alternative methodologies for more complex trading scenarios will lessen the costs and burdens on firms, FINRA notes that it will also make it more difficult for potential consumers of this information to evaluate transactions within and across firms, reducing comparability to customers. In addition, the flexibility may increase FINRA's market surveillance and rule enforcement costs.

FINRA is requesting comment on the potential costs that the revised proposal may impose on firms. FINRA is also requesting comment as to whether the revised proposal may have an unintended negative impact on dealer behavior. FINRA requests data and quantified comments where possible.

Regulatory Alternatives

FINRA recognizes that there are alternatives to the proposed approach of requiring disclosure of pricing information for trades in the same security where the firm principal and the customer trades occur on the same trading day. As discussed above, the MSRB is proposing to require disclosure of the amount of the firm's mark-up (or mark-down) for certain retail customer transactions, rather than the reference price paid by the firm and the differential between the reference price and the price paid by the customer. Under the MSRB's proposal, the firm would be required to disclose its mark-up or mark-down from the prevailing market price of a security if the firm traded as principal with a non-institutional account within a discrete time window (*e.g.*, the firm purchased the security in the two hours preceding the sale to the customer, or sold the security in the two hours following the purchase from the customer).

While FINRA believes its revised approach is likely to result in more consistent disclosures for a greater number of retail customers,[30] FINRA notes that, in many circumstances, the revised FINRA approach and the MSRB's mark-up disclosure approach would produce similar outcomes. For example, where there is a 1:1 match in a short duration of time with no intervening trades or material price movement, the mark-up/differential disclosed would be the same under the mark-up disclosure approach and the revised proposals. Similarly, if a firm was using a last-in-time methodology for calculating its reference price in a more complex trading scenario, and the price for that bond did not change significantly between the time of the firm's last purchase and the time of the trade with the customer, the differential between the price to the firm and the price to the customer would likely be comparable to the firm's mark-up calculation.

Some commenters also suggested a shorter timeframe for purpose of triggering the disclosure requirement, such as 15 or 30 minutes. While the TRACE data indicated that a majority of firm and customer trades occur within 30 minutes of each other, FINRA continues to believe that requiring disclosure for a broader time span of within the same trading day will capture additional customer trades that would benefit from the proposed disclosure and should not be excluded. FINRA also believes that a same-trading day standard will help reduce the concern that a firm might delay trading activity to avoid triggering the disclosure requirements, as it would be less likely that a firm would hold a position overnight solely to avoid the proposed disclosure requirement.

Some commenters also suggested that the proposed disclosure only be triggered where the customer trade is part of a riskless principal firm trade. FINRA believes using the riskless principal standard is too narrow[31] and often may be difficult to objectively define and implement for fixed income securities. As noted above, TRACE data indicates that there is a variance in the price differential in both riskless principal trades and trades that would not be considered riskless principal, therefore again supporting the notion that disclosure in all cases will be valuable.

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

Request for Comments

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

1. In comparison to the initial proposal, does the revised proposal alter the anticipated benefits to investors?
   - Does the revised proposal alter the ability of investors to evaluate the cost and quality of the services that firms provide, and help ensure that customers receive fair and reasonable prices?
   - Does the revised proposal alter investors' ability to obtain greater transparency into the compensation of their broker-dealers or the costs associated with the execution of their fixed income trades?
2. What kinds of costs would the revised proposal impose on firms?
   - What are the anticipated costs to firms in developing and implementing systems to comply with the revised proposal? What are the anticipated on-going costs associated with this revised proposal?
   - What are the estimates of these costs, including costs associated with updating operational systems and procedures to identify customer transactions that would be subject to disclosure, costs associated with conveying the disclosure on the customer confirmation, cost of including a link to TRACE on the customer confirmation, and costs associated with adopting policies and procedures to ensure continued compliance with the revised proposal? What are the assumptions that underlie these estimates? To what extent do these estimates differ across firms of different sizes and different business models?
3. In addition to systems modifications, are there other potential changes to firms' infrastructure that would be necessary to comply with the revised proposal? What are those modifications?

4. What factors might explain differences in mark-ups and mark-downs realized by retail transactions within the same security in the corporate and agency debt market? FINRA requests data and quantified comments.
5. Do dealers have adequate guidance to distinguish between "complex" and "non-complex" trading scenarios discussed in this proposal? If not, specifically what additional guidance would be helpful?
   - What methodologies are the dealers anticipated to employ for calculating reference prices in the complex trading scenarios?
6. Does providing flexibility to the dealers in calculating reference prices for complex trades diminish the value of these disclosures to the investors?
7. In eliminating the Qualifying Size requirement in favor of a retail customer standard, does the revised proposal better address the universe of transactions that should require confirmation disclosure?
   - Is the definition of an institutional account as set forth in Rule 4512(c) appropriate for purposes of the revised proposal?
   - Should the proposal use the term institutional investor as set forth in Rule 2110(a)(4)[32] either instead of, or in addition to, the institutional account standard that is currently proposed?
   - Should the proposal apply to investment advisory accounts or participant-directed plans that would otherwise be excluded?
8. Are the proposed exceptions for fixed price new issues, trades involving functionally separate desks or departments, and transactions between affiliates for positions that were acquired on a previous trading day appropriate?
9. Is it appropriate to allow firms to not disclose the reference price in the event of a material change in the market price for the security?
10. Real time TRACE data is available free of charge on the FINRA site for personal, non-commercial use. In addition, FINRA policy, as per Rule 7730, allow for re-distribution of real time TRACE data for personal, non-commercial use free of charge.
    - In addition to, or instead of requiring firms to provide a link to TRACE on the confirmation, are there are other ways to increase investors' awareness of, and ability to access, TRACE data? For example, should FINRA allow firms the option of making TRACE data available to their customers via their own customer portal (website)?

11. In its revised proposal, the MSRB is proposing that firms disclose the mark-up both as a total dollar amount and as a percentage of the principal amount of the customer transaction. Should FINRA also consider requiring firms to disclose additional information about the reference price, such the percentage of the price differential or a total dollar amount differential?
12. In its revised proposal, the MSRB is proposing to require firms to "look through" a transaction with an affiliated broker-dealer and use that affiliated broker-dealer's transaction with a third party in determining whether disclosure is required, and the mark-up to be disclosed. For purposes of determining whether disclosure is required, and the reference price to be used, should FINRA also consider adopting a similar affirmative requirement that would look through a firm's same-day transaction with an affiliated broker-dealer to the price of that affiliate's trade with a third party?
13. In its revised proposal, the MSRB is proposing to require firms to provide a link to EMMA on all trades with non-institutional accounts, not just those trades that are subject to the proposed disclosure requirement. Should FINRA also consider adopting this requirement?
14. In its revised proposal, the MSRB is proposing, on all trades with non-institutional accounts, to require firms to disclose the time of execution, accurate to the nearest minute, of the customer's trade. Should FINRA also consider adopting this requirement? What are the potential benefits and drawbacks of this requirement?
15. If a firm elects to use an alternative methodology for purposes of calculating the reference price, should the firm be required to describe the methodology that was used? If so, would it be appropriate for a firm to make this disclosure on its website, or through some other means?
16. The revised proposal would require firms, for purposes of establishing the reference price, to consider trades where the firm principal trade was with another customer. Would an alternative methodology be appropriate for calculating the reference price in these cases?
17. Are there alternative forms of disclosure or methods to achieve the objectives of the revised proposal and are they better suited than the revised proposal?
    - As discussed above, the MSRB is proposing to require a firm to disclose its mark-up (or mark-down) from the prevailing market price of a security if the firm traded as principal with a non-institutional account within a discrete time window (*e.g.*, the firm purchased the security in the two hours preceding the sale to the customer, or sold the security in the two hours following the purchase from the customer).

    - Are there benefits to this alternative that are not present in the revised proposal?
    - Are there limitations to this alternative that are no present in the revised proposal?
    - What would be the costs to firms to implement such an alternative disclosure? What are the assumptions that underlie those cost estimates?
    - Should FINRA require similar disclosure instead of the revised proposal?
  - Instead of requiring firms to calculate a reference price for every eligible trade, should firms be permitted to state that the firm's mark-up/mark-down will not exceed a certain specified figure unless otherwise disclosed, *e.g.*, 0.50 percent, and require firms to disclose mark-ups/mark-downs in excess of that figure?

18. In comparison to the initial proposal, would the revised proposal differently impact markets and market participants?
  - Would the revised proposal alter the incentives and dynamics of the broker-customer relationship, result in decreased liquidity in the fixed income market, cause firms to reduce service in retail-sized trades, or encourage firms to trade with customers as principal from inventory?
  - How should FINRA measure and assess these potential effects against the benefits the proposal might create?
  - In comparison to the initial proposal, would the revised proposal differently impact markets and market participants?
  - Are there other potential economic impacts to market participants of the revised proposal? Would the proposal alter the incentives and dynamics of the broker-customer-relationship? FINRA requests data and quantified comments.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. The MSRB issued a companion notice soliciting comment on a substantially similar proposal applicable to municipal securities. *See* MSRB *Regulatory Notice 14-20* (November 2014).

4. In the case of a sale to a customer, the proposal would apply to instances where the firm bought bonds as principal both prior to, and after, it sold bonds to the customer. The proposal would also apply to instances where the firm buys bonds from a customer and sells the same bonds as principal to another party on the same trading day. In that scenario, the proposal would apply to instances where the firm sold bonds as principal both prior to, and after, it bought bonds from the customer.

5. The comments received in response to *Regulatory Notice 14-52* are available on FINRA's website at *www.finra.org/notices/14-52*.

6. Rule 4512(c) defines an institutional account as an account of (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

7. The scenario was also raised where a firm trade used to calculate the reference price is later cancelled on a subsequent trade date. In such a scenario, FINRA would not require the firm to recalculate the reference price or re-issue a confirmation, but the firm would be permitted to do so at its discretion.

8. Using data from the first quarter of 2015 for corporate bonds, FINRA observed that approximately 42 percent of retail-size customer trades (100 bonds or fewer) had same-size corresponding principal trades on the same trading day. In addition, for these trades, the customer and principal trades occurred within 30 minutes of each other in approximately 96 percent of those trades.

9. Using data from the first quarter of 2015 for corporate bonds, the percentage of retail-sized trades that have off-setting firm trades (both same-size or that otherwise satisfy the customer trades) increases to 58.25 percent. For this universe of retail trades, the principal and the customer trades occurred within thirty minutes of each other in over 88 percent of those trades.

10. For the disclosure requirements to apply, there still must be an offsetting principal trade on the same day that meets or exceeds the size of the retail customer trade.

11. While FINRA believes that firms should be provided flexibility in calculating the reference price in more complex scenarios, FINRA notes that greater flexibility reduces the comparability of such disclosure across firms.

12. FINRA's data indicated that, where retail-size trades had a same-size match with a firm trade on the same trading day, over 96 percent of those matched trades occurred within 30 minutes of each other, meaning that concerns about intervening volatility or news between the firm and customer trade, while possible, are not typical and that the close time proximity of the trades further supports that the pricing information would be valuable to investors.

13. *See* MSRB *Regulatory Notice 2015-16*.

14. As described in the MSRB's notice, the prevailing market price for the customer's security would presumptively be established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with applicable MSRB rules. *See MSRB Regulatory Notice 2015-16*.

15. This analysis is both under-inclusive relative to the proposal, as it does not include retail transactions of larger size, as well as over-inclusive, as it includes non-retail trades of smaller size. Nonetheless, FINRA believes that the analysis provides useful initial evidence around an economic baseline.

16. The top 5 dealers alone accounted for more than 37 percent of the corporate bond transactions and over 34 percent of the agency debt transactions.

17. The mark-up and mark-down calculations involved matching customer trades to offsetting same-day principal trades by the same dealer in the same CUSIP. This included matching same-sized trades as well as trades of different sizes where there was no same-sized match (*e.g.*, a customer buy of 100 corporate bonds matched to two principal sells of 50 corporate bonds each). The markups (mark-downs) on customer buys (sells) correspond to the percentage difference in price in customer trades and the offsetting principal trade. In cases when the offsetting principal trade was also a customer trade, the combined mark-up and mark-down ("spread") on these roundtrip transactions was calculated as the percentage difference in price between the customer buy and the customer sell.

18. The median mark-down on these retail-sized investment grade corporate debt transactions was 0.44 percent and the 95th percentile was 1.57 percent. The corresponding two-way median spread (combined mark-up and mark-down on these roundtrip transactions) and the 95th percentile were 0.07 percent and 2.81 percent, respectively. These estimates are consistent with the academic literature on the impact of transparency and transaction costs in the corporate bond market. For example, Goldstein, Hotchkiss & Sirri (2007) estimated average two-way spreads on BBB corporate bond trades within the same day. The authors' estimates of transaction costs for retail sized trades measured in groupings from less than 10 bonds through 51-100 bonds range from 0.85 percent to 2.35 percent for a period pre- and post- introduction of public TRACE reporting. Consistent with FINRA's analysis, the authors report a material difference between the median transaction costs and the tail of the distribution. For example, the authors find that the median two-way spreads range from 0.38 percent to 2.25 percent whereas the corresponding 99th percentiles were significantly higher, ranging from 4.88 percent to 6.26 percent. Overall, the authors show that the introduction of transparency in the corporate bond market led to a decline in transaction costs. This finding is consistent with other studies, such as Edwards, Harris, and Piwowar (2007) and Bessembinder, Maxwell, and Venkataram (2006), who also find that transparency reduced transaction costs in the corporate bond market.

19. Similarly, the median mark-up and the 95th percentile for agency debt transactions of 100 bonds or less were 0.11 percent and 1.78 percent, respectively. These differences between the median mark-up/mark-down and the tail of the distribution also remain material across transactions of varying sizes within retail-sized corporate and agency debt transactions. For example, the median mark-ups for corporate debt transactions of less than 10 bonds, between 10 and 40 bonds, between 40 and 70 bonds, and between 70 and 100 bonds were 0.32 percent, 0.75 percent, 0.73 percent and 0.61 percent, respectively whereas the corresponding 95th percentiles were significantly higher (2.11 percent, 2.40 percent, 2.54 percent and 2.54 percent).
20. The difference between the median mark-up or mark-down and the tail of the distribution also remains material after accounting for differences in security characteristics. For example, the staff calculated the difference between the median and the 95th percentile mark-up and mark-down by CUSIP for all securities that had 50 or more customer trades and corresponding principal trades during the first quarter of 2015. This analysis shows that the difference between median markups and mark-downs and the tail of the distribution continues to remain material across a range of securities. For example, the difference in mark-ups and mark-downs exceeds 1.04 percent for half of the individual corporate debt securities and exceeds 1.47 percent for a quarter of the corporate debt securities. These findings suggest that the material difference between median markups and mark-downs and the tail of the distribution is not driven solely by differences in characteristics of the underlying securities.
21. These statistics were similar for trades in agency debt securities. For example, customer trades with same-sized corresponding principal trades occurred within 10 minutes of each other for approximately 91 percent and within 2 hours for more than 98 percent of the trades.
22. As discussed above, since the underlying data cannot differentiate between retail and institutional transactions, FINRA focused on customer trades of 100 bonds or less, which is intended to capture trades that are retail in nature.
23. For these calculations, dealers are identified based on unique Market Participant Identifiers (MPIDs).
24. These calculations include all customer trades where the offsetting principal trade was not a customer. For customer trades where the offsetting principal trade was also a customer, the two-way price differentials were higher. For example, the average two-way price differential was 0.85 percent for corporate debt securities and 0.65 percent for agency debt securities.
25. These results suggest that while the price differential was less than half a percent on 50 percent of these corporate debt transactions, 5 percent of the transactions had price differential of more than two percent. Similarly, for retail-sized agency debt transactions the median estimated price differential was 0.43 percent whereas the 95th percentile was 1.78 percent.
26. Consistent with the calculations for the non-complex trading scenarios, these calculations include all customer trades where the offsetting principal trades were not a customer.

27. For example, the median estimated price difference in retail-sized corporate debt transactions was 0.82 percent whereas the 95th percentile was 2.72 percent.

28. Similarly agency debt trades identified as complex scenarios were reported by 124 dealers but were concentrated among large dealers. For example, the top 20 dealers based on number of disclosure eligible trades accounted for more than 70 percent of the transactions in agency debt securities.

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

30. For example, under the mark-up disclosure approach, a non-riskless principal transaction effectuated greater than two hours apart would not be eligible to receive pricing disclosure. Similarly, firms may not use uniform approaches in calculating their mark-ups, which would reduce the comparability of this information across firms.

31. TRACE data from the first quarter of 2015 indicates that by not limiting the proposal to riskless principal trades, 38 percent more retail-size trades would have received the proposed reference price information.

32. Rule 2110(a)(4) defines an institutional investor as any "(A) person described in Rule 4512(c), regardless of whether the person has an account with a member; (B) governmental entity or subdivision thereof; (C) employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans; (D) qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans; (E) member or registered person of such a member; and (F) person acting solely on behalf of any such institutional investor."

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Attachment A

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

FINRA Rules

2230. Customer Account Statements and Confirmations

2232. Customer Confirmations

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

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

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

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

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

(B) a customer may contact the member for more information concerning the security[.];

(3) with respect to a sale to (purchase from) a non-institutional customer in a corporate or agency debt security, if the member also executes a buy (sell) transaction(s) as principal with one or multiple parties in the same security within the same trading day that equals or exceeds the size of the customer transaction:

(A) the price to the customer;

(B) the member's Reference Price;

(C) the differential between the price to the customer and the member's Reference Price; and

(D) a reference, and hyperlink if the confirmation is electronic, to the Trade Reporting And Compliance Engine (TRACE) publicly available trading data.

(c) Definitions

For purposes of this Rule, the term:

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

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

(3) "non-institutional customer" shall mean a customer account that is not an institutional account, as defined in Rule 4512(c).

(4) "Reference Price" shall mean the price of a same-day principal trade by the member in the same security. For purposes of establishing the Reference Price:

(A) A member is not required to consider a principal trade where:

(i) The member's principal buy (sell) transaction was executed by a trading desk that was functionally separate from the trading desk that executed the non-institutional customer order, including that the transactions and positions of the separate desk are not regularly used to source the retail transactions at the other desk;

(ii) The member's principal trade was executed with an affiliate of the member, where the affiliate's position that satisfied this trade was not acquired on the same trading day; or

(iii) The member acquired the security in a fixed-price offering and sold the security to non-institutional customers at the fixed price offering price on the day the securities were acquired.

(B) Where the member executes a principal trade that is the same size or greater than a customer trade within the same trading day in the same security, the Reference Price shall be the price of the principal trade.

(C) Where a single principal trade is not the same size or greater than the customer trade or where there are one or more intervening principal trades between the same or greater size trades within the same trading day, the member may use an alternative methodology to determine the Reference Price. Such methodology must be;

(i) an average weighted price of the member's same-day principal trades that either equal or exceed the size of the customer trade, or is derived from the price(s) of the member's same-day principal trades and communicates comparable pricing information to the customer;

(ii) consistently applied across the member's non-institutional customer base; and

(iii) clearly documented in the member's written policies and procedures.

(D) Where the member has documented and can demonstrate that there was a material change in the price of the security between the time of the transaction(s) that is (are) being used as the basis of the Reference Price and the time of the customer transaction, the member may elect not to disclose the Reference Price for that customer transaction, or may disclose the Reference Price together with a statement explaining such price change.

* * * * *

Attachment B

Guidelines For Permissible Methodologies in Establishing a Reference Price

1. Where there is a principal transaction and a customer transaction of the same size within the same trading day, or the principal transaction exceeds the size of the customer transaction and there are no intervening principal transactions, the price of the principal trade must be used.

   Example:

   10:00:00 AM: Firm A purchases 60 XYZ bonds from a dealer at a price of 100 for $60,000.

   10:30:00 AM: Firm A sells 60 XYZ bonds to Customer 1 at a price of 101 for $60,600.

   The firm must use the firm trade (100) as the reference price on the customer confirmation.

   If there is an intervening principal trade, irrespective of size, the firm may use an alternative methodology for calculating the reference price.

   Example: 1:1 Match with Intervening Trade

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

   10:30:00 AM: Firm A purchases 30 XYZ bonds from a dealer at a price of 100.50 for $30,150.

   15:00:00 PM: Firm A sells 100 XYZ bonds to Customer 1 at a price of 101.50 for $101,500.

   The firm is permitted to use an alternative methodology as described below.

2. Where there is not a 1:1 scenario, allow firms to calculate the reference price by a reasonable alternative methodology. We believe that a reasonable methodology could include either using the last same-day trade reported by the firm (or closest in time if reported after), or by using an average weighted price. The firm must adequately document, and consistently apply, its chosen methodology.

   Example:

   10:00:00 AM: Firm A purchases 200 XYZ bonds from a dealer at a price of 102.50 for $205,000.

   10:30:00 AM: Firm A purchases 100 XYZ bonds from a dealer at a price of 104 for $104,000.

   13:30:00 PM: Firm A purchases 500 XYZ bonds from a dealer at a price of 104.50 for $522,500.

   15:00:00 PM: Firm A sells 90 XYZ bonds to Customer 1 at a price of 105.50 for $94,950.

   No trades occur after the trade at 15:00:00.

The firm is permitted to use either the last firm trade (104.50), or the average weighted price (103.94).

Example:

10:00:00 AM: Firm A purchases 200 XYZ bonds from a dealer at a price of 102.50 for $205,000.

10:30:00 AM: Firm A purchases 100 XYZ bonds from a dealer at a price of 104 for $104,000.

13:30:00 PM: Firm A purchases 500 XYZ bonds from a dealer at a price of 104.50 for $522,500.

15:00:00 PM: Firm A sells 90 XYZ bonds to Customer 1 at a price of 105.50 for $94,950.

15:45:00 PM: Firm A purchases 150 XYZ bonds from a dealer a price of 105 for $157,500.

The firm is permitted to use either the last firm trade (105), which occurred after the last customer trade in this example, or the average weighted price (104.11).

3. Allow firms to either not disclose, or disclose with a disclaimer, pricing information for transactions where the firm has documented and can demonstrate that there was a material change in the price of the bond between the time of the firm and the customer transactions.

Example:

10:00:00 AM: Firm A purchases 200 XYZ bonds from a dealer at a price of 85 for $170,000.

10:30:00 AM: Due to news of an impending positive rating change, the prevailing market price for XYZ rises to 90.

13:30:00 PM: Firm A sells 100 XYZ bonds to Customer 1 at a price of 91 for $91,000.

Firms could either use the last firm trade (85) and provide explanatory language for the ensuing price change, or could decline to make pricing disclosure in this instance.