

Pricing Disclosure in the Fixed Income Markets

SEC Approves Amendments to Require Mark-Up/Mark-Down Disclosure on Confirmations for Trades With Retail Investors in Corporate and Agency Bonds

Effective Date: May 14, 2018

Executive Summary

The Securities and Exchange Commission (SEC) approved amendments to FINRA Rule 2232 (Customer Confirmations) that require member firms to disclose additional transaction-related information to retail customers for trades in certain fixed income securities. Specifically, amended Rule 2232 requires a member to disclose the amount of mark-up or mark-down it applies to trades with retail customers in corporate or agency debt securities if the member also executes an offsetting principal trade in the same security on the same trading day. The amended rule also requires members to disclose two additional items on all retail customer confirmations for corporate and agency debt security trades: (1) a reference, and a hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains publicly available trading data for the specific security that was traded, and (2) the execution time of the transaction, expressed to the second. These amendments will become effective on May 14, 2018.

The amended rule text is available on FINRA's website.

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Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Fixed Income
- ▶ Legal
- ▶ Operations
- ▶ Systems
- ▶ Trading
- ▶ Training

Key Topics

- ▶ Fixed Income
- ▶ Pricing Information
- ▶ TRACE
- ▶ Transaction Confirmations

Referenced Rules & Notices

- ▶ FINRA Rule 2121
- ▶ FINRA Rule 2232
- ▶ FINRA Rule 4512
- ▶ SEA Rule 10b-10
- ▶ Regulatory Notice 14-52
- ▶ Regulatory Notice 15-36

Background and Discussion

Pursuant to SEA Rule 10b-10, firms currently are required to provide transaction cost information when acting as principal with customers for equity trades; however, no comparable requirement had existed for bond trades. As part of an initiative to provide retail fixed income investors with additional information about the costs of their transactions, FINRA filed proposed amendments to Rule 2232 to require enhanced transaction cost and related information on customer confirmations.¹

FINRA's amendments to Rule 2232 were developed as the result of a multi-year process during which FINRA twice solicited feedback on related proposals.² Throughout the process, FINRA worked closely with the Municipal Securities Rulemaking Board (MSRB) to develop similar rules, as appropriate, to ensure consistent disclosures to customers across debt securities and to reduce the operational burdens for firms that trade multiple fixed income securities. The SEC approved FINRA's amendments to Rule 2232, as well as the MSRB's parallel confirmation disclosure proposal, on November 17, 2016.³

Mark-Up Disclosure Requirements

When Disclosure is Required

New Rule 2232(c) requires members to disclose to a non-institutional customer⁴ the amount of mark-up or mark-down⁵ the customer paid for a trade in a corporate or agency debt security,⁶ if the member also executes one or more offsetting principal trades in the same security on the same trading day which in the aggregate meet or exceed the size of the customer trade.

The following example explains how the "offsetting" language that describes when disclosure is triggered under the rule is intended to operate: If a member purchases 100 bonds at 9:30 a.m., and then sells to three customers, who each buy 50 bonds in the same security on the same day, without purchasing any more of the bonds, the rule requires mark-up disclosure on two of the three trades, since one of the trades would need to be satisfied out of the member's prior inventory, or its short position, rather than offset by the member's same-day principal transaction.⁷

FINRA notes that a disclosure obligation under Rule 2232(c) could be triggered by an offsetting principal trade executed by a member's affiliate. Specifically, if a member's offsetting principal trade is executed with a broker-dealer affiliate and did not occur at arm's length,⁸ the member is required to "look through" to the time and terms of the affiliate's trade to comply with the rule.

New Rule 2232(d) contains two exceptions to the mark-up disclosure requirements of Rule 2232(c). First, mark-up disclosure is not triggered by principal trades that a member executes on a trading desk that is functionally separate from a trading desk that executes customer trades, provided the member maintains policies and procedures reasonably designed to ensure that the functionally separate trading desk has no knowledge of the customer trades.⁹ Second, mark-up disclosure does not need to be provided for bonds that are acquired by a member in a fixed-price offering and sold to non-institutional customers at the same offering price on the same day the member acquired the bonds.

Members may develop reasonable policies and procedures to identify and account for offsetting trades that trigger the disclosure obligations of Rule 2232(c). Members may also choose to provide mark-up disclosure more broadly, for example to all trades with retail customers.

Methods to Calculate and Disclose Mark-Ups

Members need to calculate the mark-up that is disclosed on a customer confirmation from the prevailing market price (PMP) for the security, consistent with existing FINRA Rule 2121 (Fair Prices and Commissions) and the supplementary material thereunder, particularly Supplementary Material .02 (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities). Members may base their mark-up calculations for confirmation disclosure purposes on the information they have available to them as a result of reasonable diligence at the time they input relevant transaction information into systems to generate confirmations. In other words, amended Rule 2232 does not prevent members from maintaining real-time, intra-day confirmation generation processes. Members can engage third-party service providers to facilitate mark-up disclosure consistent with Rule 2232; however, members retain compliance responsibility and are expected to exercise due diligence and oversight over third party relationships. Members may also choose to automate their mark-up disclosure calculation process according to reasonable, consistently applied policies and procedures, if consistent with Rule 2121.

Where mark-up disclosure is provided on customer confirmations, Rule 2232(c) requires firms to express the disclosed mark-up as both a dollar amount and a percentage of PMP.¹⁰ Members may include accompanying language to provide explanation of mark-up-related concepts, or a member's particular methodology for calculating mark-ups, provided such statements are accurate. However, members may not label mark-ups as "estimated" or "approximate" figures.¹¹

Requirement to Disclose a Reference or Link to Security-Specific Trade Data

For all trades with non-institutional customers in corporate and agency debt securities, whether mark-up disclosure is triggered or not, new Rule 2232(e) requires members to provide a reference, and a hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains TRACE publicly available trading data for the specific security that was traded, along with a brief description of the type of information available on that page.¹²

FINRA noted during the rulemaking process that it was working to develop a short Uniform Resource Locator (URL) to try to mitigate the operational burdens of this requirement.¹³ Based on a variety of factors, including logistical concerns such as length of the link and space available on confirmations, discussions with member firms, as well as research into investor preferences, FINRA has established the following URL: <http://bondfacts.finra.org/<CUSIP>>. Paper confirmations would be required to include this URL in print form; electronic confirmations would be required to include this URL as a hyperlink to the web page.

FINRA believes this URL is consistent with the principles it discussed during the rulemaking process, most notably, the need to develop a short, uniform link template that could be subject to automation by members. FINRA also notes that this URL is similar in length and convention to the URL that the MSRB will require for confirmations for transactions in municipal securities with retail customers. Should members wish to provide feedback on the URL that FINRA has chosen, FINRA will consider this input.

Time of Execution Disclosure Requirement

Rule 2232(e) further requires members to disclose the time of execution, expressed to the second, for all non-institutional customer trades in corporate and agency debt securities. As with the URL requirement, trade time disclosure is required even in cases where mark-up disclosure is not triggered. Providing customers the time of execution will assist them in identifying their individual trade when accessing the TRACE publicly available information.

Implementation Period

The effective date for the above-described amendments to Rule 2232 is May 14, 2018. This effective date, which is eighteen months from when the amendments were approved by the SEC, is the same as the effective date for the MSRB's parallel confirmation disclosure requirements.¹⁴

FINRA recognizes members may still have specific implementation questions and remains committed to working closely with the industry and MSRB during the implementation period to issue further guidance as necessary.

Endnotes

1. See Securities Exchange Act Release No. 78573 (August 15, 2016), 81 FR 55500 (August 19, 2016) (Notice of Filing of SR-FINRA-2016-032) ("Proposal").
2. See [Regulatory Notice 14-52](#) (November 2014) and [Regulatory Notice 15-36](#) (15-36). The proposals contained in these *Regulatory Notices*, and how they differ from the amendments to Rule 2232 that FINRA ultimately filed with the SEC, are discussed in the proposal, *supra* note 1.
3. See Securities Exchange Act Release No. 79346 (November 17, 2016), 81 FR 84659 (November 23, 2016) (Order Approving SR-FINRA-2016-032) ("Approval Order"); Securities Exchange Act Release No. 79347 (November 17, 2016), 81 FR 84637 (November 23, 2016) (Order Approving SR-MSRB-2016-12).
4. The term "non-institutional customer" is defined in Rule 2232(f)(4) to mean a customer with an account that is not an institutional account. The term "institutional account" is defined in Rule 4512(c) to mean 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."
5. For ease of reference, unless otherwise noted, the term "mark-up" refers to mark-ups and mark-downs, collectively.
6. The terms "corporate debt security" and "agency debt security" are defined in Rules 2232(f)(1) and (2), respectively.

7. See Approval Order, *supra* note 3, at 84663 (discussing FINRA's response to comments submitted to the SEC concerning the proposed amendments.)
8. The term "arms-length transaction" is defined in Rule 2232(f)(3) to mean "a transaction that was conducted through a competitive process in which non-affiliate firms could also participate, and where the affiliate relationship did not influence the price paid or proceeds received by the member." FINRA has noted that as a general matter, it expects the competitive process used in an "arms-length" transaction to be one in which non-affiliates have frequently participated. See Approval Order, *supra* note 3, at 84662 n. 43.
9. For example, this exception allows an institutional desk within a firm to service an institutional customer without necessarily triggering the disclosure requirement for an unrelated trade performed by a separate retail desk within the firm. However, given the "no knowledge" provision of this exception, a firm could not avoid triggering the mark-up disclosure requirement if trades executed on an institutional desk were used to source transactions at the retail desk. See Proposal, *supra* note 1, at 55502.
10. Specifically, mark-ups must be disclosed on confirmations as a total dollar amount (*i.e.*, the dollar difference between the customer's price and the security's PMP), and as a percentage amount (*i.e.*, the mark-up's percentage of the security's PMP).
11. See Approval Order, *supra* note 3, at 84671.
12. Each security-specific web page will include information about the prices of other transactions in the same bond, as well as additional market data and educational material that FINRA believes will be useful to retail investors.
13. See Approval Order, *supra* note 3, at 84667 (citing to FINRA's response to comments).
14. See MSRB Regulatory Notice 2016-28 (November 2016).