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FINRA Update

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Financial Industry Regulatory Authority Issues Guidance Regarding New Enhanced Confirmation Disclosure Requirements

The US Securities and Exchange Commission (SEC or Commission) recently approved amendments to Financial Industry Regulatory Authority (FINRA) Rule 2232, which will "require member firms to disclose additional transaction-related information to retail customers for trades in certain fixed income securities[, including] … the amount of mark-up or mark-down [(collectively, Mark-Ups)] 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."[1] The amendments are not effective until May 14, 2018; however, FINRA has already issued guidance regarding the amendments (Guidance) and has also indicated that additional guidance may be forthcoming.[2] The Guidance relates to the following four areas: (1) Mark-Up disclosure requirements, (2) content and format of Mark-Up disclosure, (3) determination of prevailing market price (PMP), and (4) requirements related to security-specific URL disclosures and time of execution. Below is a summary of certain aspects of the Guidance.

Mark-Up Disclosure Requirements

In the Guidance, FINRA noted that "[a] member is required to disclose on a customer confirmation the [M]ark-[U]p on a transaction in corporate and agency debt securities with a non-institutional customer if the dealer also executes one or more offsetting principal transaction(s) on the same trading day as the customer transaction in an aggregate trading size that meets or exceeds the size of the customer trade."[3] FINRA clarified that the Mark-Up disclosure requirements only apply to corporate and agency debt securities (including certain hybrid securities) and therefore do not apply to other debt securities, such as US Treasury Securities or Securitized Products.[4] There are two exceptions to the Mark-Up requirement: (a) if the "principal trades [are executed] on a trading desk that is functionally separate from a trading desk that executes customer trades, provided the [firm] maintains policies and procedures reasonably designed to ensure that the functionally separate trading desk had no knowledge of the customer trades;" and (b) if the firm "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."[5]

FINRA warned firms that they would violate FINRA rules if they intentionally delayed execution of a transaction "to avoid triggering the [M]ark-[U]p

disclosure requirements," but also reminded firms that the "Mark-[U]p disclosure is required only where a customer trade offsets a same-day principal trade in whole or in part."[6] However, if a firm utilizes an affiliate to execute its offsetting principal trade, a firm also needs to determine whether (a) the transaction was "arms-length," and (b) it needs to "look-through" the transaction to determine if the transaction is subject to the Mark-Up disclosure requirements.[7]

FINRA Rule 2232(f)(3) defines "arms-length transaction" 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."[8] FINRA noted that the determination of whether a transaction was "arms-length" is necessary when an affiliate executes a firm's offsetting principal trade because "[i]f a member's offsetting principal trade is executed with a broker-dealer affiliate and did not occur at arm's length, the member is required to 'look through' to the time and terms of the affiliate's trade with a third party to determine whether [M]ark-[U]p disclosure is triggered under rule 2232."[9] "Look throughs" are only required for transactions involving affiliate non-arms-length transactions.[10] FINRA noted that it "would not view a process, like a request for pricing protocol or posting of bids and offers, as competitive if non-affiliates responded to requests or otherwise participated in only isolated or limited circumstances" as FINRA anticipates a competitive process to constitute "one in which non-affiliates have frequently participated."[11]

Content and Format of Mark-Up Disclosure

In the Guidance, FINRA noted that when the Mark-Up disclosure requirement is triggered, firms must ensure that the "[M]ark-[U]p … be calculated and disclosed as the total amount per transaction" and located in a "naturally visible place."[12] Furthermore, "the inclusion of a link on the customer confirmation that a customer could click to obtain his or her [M]ark-[U]p disclosure would not satisfy the requirements of Rule 2232."[13] Firms are permitted to explain "[M]ark-[U]p related concepts" or Mark-Up calculation methodologies as long as they are "accurate and not misleading;" however, firms "may not label [M]ark-[U]ps as 'estimated' or 'approximate' figures, or use other such labels."[14] The Guidance also clarified the treatment of negative Mark-Ups. FINRA noted that firms may not automatically reflect a Mark-Up of zero when the Mark-Up is negative; rather, firms should disclose the negative Mark-Up or indicate "N/A" as long as the confirmation explains what "N/A" means and why it was included in the confirmation.[15]

Prevailing Market Price

The Guidance reminds firms of their obligation to calculate the PMP of a bond in accordance with FINRA Rule 2121 and supplementary material thereto, including Supplementary Material .02 (Waterfall Analysis) and notes that firms may "rely on reasonable policies and procedures to facilitate PMP determination, provided the policies and procedures are consistent with Rule 2121 and are applied consistently."[16] FINRA Rule 2121, Supplementary Material .02 provides, in part, that:

> A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price. Presumptively for purposes of … Supplementary Material .02, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with FINRA pricing rules.[17]

FINRA recognized that firms may determine PMP at various points of time during the day, but that the "timing of the determination must be

applied consistently across all transactions in corporate and agency debt securities."[18]

FINRA also provided guidance on the determination of whether a trade would be deemed contemporaneous, noting that

> [m]embers may reasonably establish an objective set of criteria to determine whether a trade is contemporaneous … [and that] members should include in their policies and procedures an opportunity to review and override the automatic application of default proxies … [g]iven the different trading characteristics of different debt securities, and relevant court and SEC case law.[19]

FINRA also reminded firms that Mark-Up disclosure and "contemporaneous" determinations are distinct from each other.[20]

The determination of contemporaneous costs is further complicated when there are multiple contemporaneous trades. FINRA noted that firms "may rely on reasonable and consistently applied policies and procedures that employ methodologies to establish PMP where they have multiple contemporaneous principal trades [and that firms] may adjust their contemporaneous cost where a member's offsetting trades that trigger disclosure under Rule 2232 are both customer transactions."[21] FINRA warned firms that they may not apportion their expected aggregate monthly fees to individual contemporaneous transactions to be included in their contemporaneous costs, but that they may include transaction fees in the cost (as long as they are also reported as such).[22]

FINRA also provided guidance on various situations that may allow a firm to overcome the presumption that a firm's contemporaneous cost is the best measure of PMP and provided detailed guidance on conducting the Waterfall Analysis. In the Guidance, FINRA also reminded firms that they should retain their PMP determinations.[23]

Security-Specific URL Disclosures Time of Execution

FINRA Rule 2232(e) provides that

> [f]or all transactions in corporate or agency debt securities with non-institutional customers, the member shall also provide on the confirmation: (1) a reference, and hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains Trade Reporting And Compliance Engine (TRACE) publicly available trading data for the specific security that was traded, in a format specified by FINRA, along with a brief description of the type of information available on that page; and (2) the execution time of the customer transaction, expressed to the second.[24]

In the Guidance, FINRA reminded firms that the security-specific URL and time of trade disclosure requirements are not "limited to circumstances where [M]ark-[U]p disclosure is triggered; because [they] appl[y] to all non-institutional customer trades in corporate and agency debt securities, [they are] required where [M]ark-[U]p disclosure is not."[25] In the Guidance, FINRA provided the template for the required URL, noting that it is operational, and also indicated that firms "must include a brief description of the type of information that is available on the security-specific web page for the subject security, which 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."[26]

FINRA also noted in the Guidance that, for FINRA purposes, the time of execution should be "expressed to the second," but that the MSRB may publish different guidance on that point.[27]

FINRA has encouraged firms to reach out to FINRA with questions on the new enhanced confirmation disclosure rules. As firms prepare for the

implementation of the amendments, we anticipate that additional questions will arise and that FINRA will likely issue additional guidance regarding the rule.

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NOTES

1 *See* FINRA Regulatory Notice 17-08—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 (Feb. 2017).

2 *See* Fixed Income Confirmation Disclosure: Frequently Asked Questions (last updated July 2017) (Confirmation Disclosure FAQs). FINRA specifically stated in the Confirmation Disclosure FAQs that it worked with the Municipal Securities Rulemaking Board (MSRB) in crafting the Guidance and that the MSRB also issued its own guidance. FINRA noted that the MSRB and FINRA guidance may differ in certain instances and that FINRA has indicated within the Guidance where the MSRB and FINRA guidance differs.

3 *See* Confirmation Disclosure FAQs at Q. 1.1. FINRA noted that the mark-up disclosure requirement only applies to trades with non-institutional customers. Registered investment advisers are deemed to be institutional customers under FINRA Rule 2232. Therefore, the mark-up disclosure requirement would not apply to transactions with registered investment advisers "even where the registered investment adviser with whom the dealer transacted later allocates all or a portion of the securities to a retail account or where the transaction is executed directly for a retail account if the investment adviser has discretion over the transaction." *See id.* at Q. 1.6. Firms can choose to provide the mark-up disclosure voluntarily; however, "voluntary disclosure should also follow the same format and labeling requirements applicable to mandatory disclosure." *See id.* at Q. 1.8. Furthermore, introducing or correspondent broker-dealers are "ultimate[ly] responsibl[e] for compliance with the [Mark-Up] disclosure requirements." *See id.* at Q. 1.9.

4 *See* Confirmation Disclosure FAQs at Q. 1.10 and 1.11.

5 *See id.* at 1.7; *see also* FINRA Rule 2232(d).

6 *See* Confirmation Disclosure FAQs at Q. 1.1 and 1.2.

7 *See id.* at Q. 1.3.

8 *See* FINRA Rule 2232(f)(3).

9 *See* Confirmation Disclosure FAQs at Q. 1.3.

10 *See* FINRA Rule 2232(c)(2).

11 *See* Confirmation Disclosure FAQs at Q. 1.4.

12 *See id.* at Q. 2.1 and 2.2.

13 *See id.* at Q. 2.2.

14 *See id.* at Q. 2.3.

15 *See id.* at Q. 2.4.

16 *See* Confirmation Disclosure FAQs at Q. 3.1. FINRA also noted that firms can utilize automated systems and/or third-party vendors to assist with the Mark-Up disclosure requirements, but reminded firms that they will retain the ultimate responsibility for ensuring compliance with the applicable FINRA rules and that firms "must exercise due diligence and oversight over their third party relationships." *See id.* at Q. 3.6 and 3.8.

17 *See* FINRA Rule 2121, Supplementary Material .02(b)(1).

18 *See* Confirmation Disclosure FAQs at Q. 3.4. FINRA also noted that it "recognized during the rulemaking process that reasonable policies and procedures could result in different firms making different PMP determinations for the same security." *See id.* at Q. 3.8.

19 *See* Confirmation Disclosure FAQs at Q. 3.9.

20 *See id.* at Q. 3.10.

21 *See id.* at Q. 3.11 and 3.13.

22 *See id.* at Q. 3.14 and 3.15.

[23] *See id.* at Q. 3.28.

[24] *See* FINRA Rule 2232(e).

[25] *See* Confirmation Disclosure FAQs at Q. 4.1 and 4.3. FINRA also noted that "[d]isclosure of the time of execution and security-specific URL is not required for transactions with an institutional customer," which would include accounts of registered investment advisers. *See id.* at Q. 4.6.

[26] *See id.* at Q. 4.4 and 4.5.

[27] *See id.* at Q. 4.2.