WILMERHALE

SECURITIES

July 24, 2017

Broker-Dealer Alert

FINRA and the MSRB Issue FAQs on Bond Mark-Up Disclosure

By Paul R. Eckert, Bruce H. Newman and Daniel J. Martin

On July 12, 2017, the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB) published new implementation guidance on the bond mark-up disclosure requirements set to take effect next spring.[1] Under amended FINRA Rule 2232 and amended MSRB Rules G-15 and G-30, effective May 14, 2018,[2] dealers will be required to disclose on retail customer confirmations their mark-ups on most municipal and corporate bond transactions, calculated from the bond's prevailing market price (PMP).[3]

Key insights from the new implementation guidance are summarized below. The guidance, provided in the form of frequently asked questions (FAQs), attempts to clarify when and how mark-ups should be disclosed and how to determine PMP, among other topics. Nevertheless, the FAQs may raise new questions as dealers work to overhaul their systems to comply with the controversial new requirements before the May 2018 deadline. FINRA and the MSRB coordinated on the publication of the FAQs, consulting with the Securities and Exchange Commission (SEC) in advance. Both FAQs use the same numbering scheme (followed here), with minimal differences between the two versions.

When Mark-Up Disclosure Is Required

Non-Institutional Customers. Under FINRA Rule 2232 and MSRB Rule G-15, the mark-up disclosure requirement applies only to trades with non-institutional customers. FAQ 1.6 clarifies that the requirement does not extend to transactions involving a dealer and a registered investment adviser—considered an institutional customer for the purpose of the rules—even when the adviser allocates all or a portion of a transaction to a retail account or trades directly for a retail account.

Voluntary Disclosure. FAQ 1.8 clarifies that dealers may voluntarily provide mark-up disclosure on additional transactions that do not trigger mandatory disclosure; however, such voluntary disclosure should follow the "same format and labeling requirements applicable to mandatory disclosure." Presumably, this guidance applies only to transactions with retail customers in corporate or agency debt securities that, but for the lack of a qualifying offsetting trade, would

---

[1] *See* FINRA, "Fixed Income Confirmation Disclosure: Frequently Asked Questions" (July 12, 2017); MSRB Regulatory Notice 2017-12, "MSRB Provides Implementation Guidance on Confirmation Disclosure and Prevailing Market Price" (July 12, 2017).

[2] Unless otherwise noted, references in this alert pertain to the amended rules, effective May 14, 2018.

[3] *See* Exchange Act Release No. 79346 (Nov. 17, 2016), 81 Fed. Reg. 84659 (Nov. 23, 2016) (SR-FINRA-2016-032) (FINRA Approval Order); Exchange Act Release No. 79347 (Nov. 17, 2016), 81 Fed. Reg. 84637 (Nov. 23, 2016) (SR-MSRB-2016-12) (MSRB Approval Order). For additional detail on the amended rules and the rulemaking process, see our earlier client alert, "SEC Approves Bond Mark-Up Disclosure Rules" (Nov. 29, 2016).

otherwise be subject to the disclosure requirements of the rule.[4] As the rulemaking focused exclusively on this category of transactions, we do not believe that this guidance should be interpreted to prescribe or limit the form and content of accurate post-trade price disclosure in other types of debt securities (e.g., asset-backed securities, Treasury securities) that are not currently subject to the rule and that trade and price differently, often in entirely institutional markets and with bespoke documentation.

Introducing/Clearing Dealers. FAQ 1.9 explains that the introducing (i.e., correspondent) broker-dealer "bears the ultimate responsibility" for mark-up disclosure, but "may use the assistance of a clearing dealer, as it may use other third-party service providers subject to due diligence and oversight."

Application to "Securitized Products" and "Asset-Backed Securities." FAQ 1.11, which is unique to the FINRA context, is confusing because it uses a defined term ("Securitized Product") without acknowledging that FINRA Rule 2232(f) uses a similar but different defined term, "Asset-Backed Security." Asset-Backed Security is basically defined in Rule 6710(cc) as a subset of Securitized Products. By having Rule 2232(f) define "corporate debt security" to exclude an Asset-Backed Security as defined in Rule 6710(cc), certain types of Securitized Products (as defined by Rule 6710(m)) would actually be included in the technical definition of corporate debt security—such as commercial mortgage-backed securities; mortgage-backed securities; and collateralized debt, loan and bond obligations. If the FINRA staff intends to exclude all Securitized Products as defined in FINRA Rule 6710(m) from the operation of Rule 2232(f), it should use that term in the rule. If not, FAQ 1.11 should be clarified to make clear that certain Securitized Products are in fact subject to Rule 2232(f).

Content and Format of Mark-Up Disclosure

Total Dollar Amount. FAQ 2.1 clarifies that the mark-up should be disclosed as the total dollar amount per transaction. Accordingly, disclosure on a per bond basis (e.g., $9.45 per bond) would not satisfy the requirement. This interpretation seems a relatively straightforward reading of the language in FINRA Rule 2232(c) and MSRB Rule G-15(a)(i)(A)(1)(e). It does, however, reflect a regulatory choice somewhat at odds with earlier efforts to mandate publication of equity mark-up and commission schedules on a per share/per trade basis to enhance "a retail customer's ability to compare equity commissions among members."[5]

Location on the Confirmation. MSRB Rule G-15(a)(i)(E) requires that the disclosure appear on the front of a printed customer confirmation, but the amended FINRA rule did not specify any particular location. FAQ 2.2 clarifies that, for the purpose of the FINRA requirement, disclosure "should appear in a naturally visible place, for example, on the front of the confirmation for printed confirmations."

Negative Mark-Ups. One of the challenges confronted by FINRA and the MSRB when they chose not to fashion a disclosure obligation solely around "riskless principal" transactions was that some "offsetting" same-day trades will inevitably have so-called negative mark-ups; i.e., the dealer's acquisition price will be higher than its sale price. As investors tend not to associate negative figures with the term "mark-up," the obligatory disclosure risks investor confusion. FAQ 2.4 explains that dealers "may not disclose a mark-up of zero where the mark-up is not, in fact, zero." However, rather than printing a negative mark-up, dealers may disclose "N/A" so long as the confirmation "also includes a brief explanation of the 'N/A' disclosure and the reason it has

[4] That is, those transactions subject to the hyperlink and execution time disclosure requirements of FINRA Rule 2232(e) and MSRB Rule G-15(a)(i)(A)(2) / G-15(a)(i)(D)(4), but that do not have an offsetting transaction that triggers the mark-up disclosure requirements of FINRA Rule 2232(c) and MSRB Rule G-15(a)(i)(F).
[5] *See* FINRA Reg. Notice 11-08 (Feb. 2011), at 7-8.

been provided." Alternatively, dealers may choose to provide an explanation for trades with disclosed negative or zero mark-ups.

Determining Prevailing Market Price

Reliance on Third-Party Vendors. FAQ 3.6 provides that dealers may engage third-party vendors to perform some or all of the steps of the PMP calculation required under FINRA Rule 2121 and MSRB Rule G-30; however, dealers "must exercise due diligence and oversight" to ensure that the PMP is determined in accordance with the rules. Similarly, FAQ 3.7 notes that a dealer should have a "reasonable basis" for relying on a third-party pricing service's methodology for determining PMP. In this regard, a dealer should conduct periodic reviews to ensure that the prices provided by the pricing service do not substantially differ from the prices at which actual transactions in the relevant securities occurred. This interpretation is consistent with FINRA's response to comments in November 2016 and is consequential primarily for its recognition that member firms "would not be prohibited" from relying on "third party service providers to document and perform the steps of the Rule 2121 analysis" and Rule 2232 obligations.[6] The reminder as to due diligence and oversight obligations is generally consistent with prior guidance.[7] The FAQs emphasize that, as a policy matter, FINRA and the MSRB do not endorse or approve the use of any specific vendors.

"Contemporaneous" Trades. PMP is presumptively established by referring to the dealer's "contemporaneous cost." FAQ 3.9 explains that dealers may establish objective criteria to automatically determine whether a trade is "contemporaneous," so long as such criteria are based on reasonable diligence. Nevertheless, FINRA and the MSRB caution that "it likely would not be reasonable for a dealer's policies and procedures to determine categorically that all transactions that occur outside of a specified time frame are not 'contemporaneous.'" As a result, dealers' policies and procedures should include "an opportunity to review and override the automatic application of default proxies (e.g., by reconsidering the application for transactions identified through reasonable exception reporting and specifying designated time intervals (or market events) after which such proxies will be reviewed)."

Imputed Mark-Ups and Mark-Downs. FAQs 3.12 and 3.13 note that dealers may adjust their contemporaneous cost where the offsetting trades are both customer transactions, to account for the mark-up or mark-down included in the customer price. This interpretation is consistent with long-standing mark-up case law compelling the consideration of imputed mark-ups and mark-downs when using customer transactions to establish PMP.[8]

Objective Proxies for Elements of the Waterfall. FAQ 3.19 allows dealers to use objective criteria as a proxy for elements of the waterfall that they cannot reasonably ascertain. For example, the FAQ suggests it would be reasonable to assume that transactions at or above $1 million par amount involve institutional customers.

"Similar" Securities. Under FAQ 3.24, assuming a dealer's process for identifying "similar" securities for best execution purposes is reasonable, a dealer may rely on that same process to identify "similar" securities in connection with determining PMP.

---

[6] Letter from Alexander Ellenberg, FINRA, to Brent J. Fields, SEC, at 9 (Nov. 14, 2016).
[7] Outsourcing, NASD NTM 05-48 (July 2005); Third Party Service Providers, FINRA Reg. Notice 11-14 (Mar. 2011).
[8] "Generally, one looks to inter-dealer trades to determine prevailing market price. Where there is no inter-dealer trade available, contemporaneous cost may be determined based upon the price the dealer pays to purchase the security from a customer, with 'an imputed markdown to the [dealer's] purchase price to reflect the fact that the price at which a dealer purchases securities from retail customers generally is less than the amount that the dealer would have paid for the security in the inter-dealer market.'" *In re Goldman Sachs*, NASD AWC No. CMS040106, at 5 n.6 (July 15, 2004) (gathering citations); *see also In re Miller Tabak Roberts Securities*, LLC, NASD AWC No. CMS040112, at 4 n.6 (July 22, 2004) (same).

Books and Records. FAQ 3.28 requires dealers to memorialize and retain their PMP determinations for every bond trade in their books and records. Notably, this FAQ could be read to impose a new, general obligation to create and retain a record of PMP insofar as it suggests that PMP be determined and retained for each and every transaction—whether or not subject to FINRA Rule 2232(c)'s or MSRB Rule G-15(a)(i)(F)'s mark-up disclosure rule, and without regard to whether a dealer is rebutting the presumption of contemporaneous cost under FINRA Rule 2121.02(b)(5) or MSRB Rule G-30.06(a)(v).[9] FINRA Rule 2232 and MSRB Rule G-15 unequivocally created a new recordkeeping obligation with respect to transactions subject to FINRA Rule 2232(c) and MSRB Rule G-15(a)(i)(F). Similarly, FINRA Rule 2121.02(b)(5) (and its predecessors) and MSRB Rule G-30.06(a)(v) made clear that member firms would be expected to justify and document alternative measures of PMP. Indeed, in 2005, FINRA disclaimed any broader recordkeeping requirement related to PMP to excuse the application of the Paperwork Reduction Act of 1995 and certain Exchange Act rulemaking obligations.[10] If FAQ 3.28 was intended to impose a broader PMP recordkeeping obligation, it raises a number of issues in terms of both its validity and its application; for example, transactions that are currently subject to the so-called QIB exception are not subject to FINRA Rule 2121 at all, making PMP determinations irrelevant. In our view, FINRA and the MSRB should make clear that FAQ 3.28 is limited to those transactions subject to FINRA Rules 2232(c) and/or 2121.02(b)(5) and MSRB Rules G-15(a)(i)(F) and/or Rule G-30.06(a)(v). FINRA and the MSRB note that they expect PMP documentation to be "an important component of a firm's system to supervise compliance" with the rules—whether those rules stretch beyond FINRA Rules 2232(c) and 2121.02(b)(5) and MSRB Rules G-15(a)(i)(F) and Rule G-30.06(a)(v) is regrettably unclear. However broad in scope, the FAQ speaks only to PMP retention itself, and does not purport to require firms to retain assumptions or calculations underlying PMP.

PMP Determination and "Subsequent Trades." FAQ 3.29 permits dealers "to determine PMP for mark-up disclosure purposes at the time of entry of information into systems for confirmation generation" even though the "mark-up disclosed may not reflect subsequent trades that could be considered 'contemporaneous' under existing Rule 2121 guidance." FAQ 3.9 addresses an awkwardness that flows from the deliberately loose definition of "contemporaneous cost"—namely, the possibility that a subsequent transaction can set the PMP for an earlier-in-time transaction. Certainly the definition of "contemporaneous cost" in FINRA Rule 2121.02(b)(3) and MSRB Rule G-30.06(a)(iii) emphasizes temporal proximity between the "subject transaction" and its "contemporaneous" cost (in the event of a mark-up) or proceeds (in the event of a mark-down). But apart from riskless principal transactions in which the offsetting legs of a transaction are known at the time of execution, prior guidance and case law have never formally embraced the notion that subsequent transactions can establish the PMP for an earlier-in-time transaction. (It's usually the other way around.) And while widely used surveillance and supervisory reports use lookback windows to flag potential mark-up concerns for further review—and may call into question the validity of the PMP (or mark-down) determined at the time of the "subject transaction"—the use of subsequent transactions in this fashion is uncontroversial and, although there is some frustration at the risk of hindsight bias, has informed countless FINRA mark-up investigations over the years.[11] However, because the very objective of FINRA Rule 2121.02

---

[9] Specifically, FAQ 3.28 provides in relevant part "[FINRA/The MSRB] believes that dealers should keep records to demonstrate their compliance with [Rule 2121/Rule G-30], particularly where they have the evidentiary burden to demonstrate why a contemporaneous transaction was not the best measure of PMP for a given trade."

[10] Letter from Sharon Zackula, NASD, to Katherine A. England, SEC, at 3-4 & n.15, 21 (Oct. 4, 2005) ("The position that contemporaneous cost is presumed to be the best measure or proxy of the PMP of a security, including a debt security, is based upon NASD's mark-up policy and longstanding precedent regarding fair mark-ups. . . . The argument that the Proposal creates new information and record-keeping costs and burdens is erroneous; in fact, such requirements exist today.") (citing cases addressing contemporaneous cost presumptions).

[11] *See, e.g.*, *In re Goldman Sachs & Co.*, NASD AWC No. CMS040106, at 4 (July 28, 2004) (introducing the terms "virtually simultaneous" and "essentially riskless" into the mark-up lexicon).

was to provide guidance to dealers about how to determine PMP *at the time of pricing*,[12] neither existing Rule 2121 guidance nor the laws of physics can reasonably be construed as compelling the consideration of future transactions as part of a dealer's PMP determination.

Time of Execution and Security-Specific URL Disclosures

Time of Execution—Institutional Accounts. Under FINRA Rule 2232 and MSRB Rule G-15, dealers must disclose the time of execution[13] for all non-institutional customer trades, even where mark-up disclosure is not triggered. With respect to the MSRB rule, FAQ 4.1 provides that, for transactions in municipal fund securities and those for an institutional account, dealers may instead include on the confirmation "a statement that the time of execution will be furnished upon written request of the customer."

Conclusion

The May 14, 2018, implementation deadline is fast approaching. Many of the FAQs provide helpful guidance regarding some of the key issues raised by dealers throughout the course of the rulemaking process and subsequent implementation period, particularly with respect to reliance on third-party vendors to automate the PMP determination. Nevertheless, as we have noted, some of the FAQs raise further questions and concerns that we hope FINRA and the MSRB will address. Both FINRA and the MSRB have invited firms to submit additional questions and topics throughout the implementation period, so it is possible we will see updated or revised guidance over the coming months.

[12] *See, e.g.*, Exchange Act Release No. 55638 (Apr. 16, 2007), 72 Fed. Reg. 20150, 20151 (Apr. 23, 2007) ("[The Debt Mark-Up Interpretation] sets forth a sequence of criteria and procedures that a dealer must consider *when determining prevailing market price*.") (emphasis added).
[13] Under the FINRA rule, time of execution must be reported to the second. Under the MSRB rule, time of execution must be reported to the minute.

For more information on this or other broker-dealer matters, contact:

Paul R. Eckert +1 202 663 6537 paul.eckert@wilmerhale.com
Bruce H. Newman +1 212 230 8835 bruce.newman@wilmerhale.com
Daniel J. Martin +1 202 663 6469 daniel.martin@wilmerhale.com