December 10, 2014

# FINRA and MSRB Seek Disclosure of Fixed-Income Price Differentials

*The respective proposals would require disclosure of price differentials in certain same-day fixed-income transactions that involve retail customers and go beyond existing price differential disclosure requirements in equity transactions.*

In coordinated regulatory notices to their respective members, the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB) are seeking comment on proposed rules that would require firms for same-day, retail-size fixed-income principal transactions to disclose on customer confirmations (1) the price to the customer, (2) the price to the firm of a transaction in the same security, and (3) the difference between those two prices.[1] As explained in the notices, FINRA and MSRB developed the proposed disclosure requirements in response to recommendations in the U.S. Securities and Exchange Commission's (SEC's) 2012 *Report on the Municipal Securities Market* regarding enhanced pricing and markup disclosures to customers in municipal bond transactions.[2] However, as explained below, the proposed disclosure requirements go significantly beyond what firms currently have to disclose on confirmations for equity riskless principal transactions and also appear to go beyond the recommendations in the municipal securities report. In addition, the proposed disclosure requirements will likely require firms to make significant and costly changes to their order management and other back-office systems used to generate transaction confirmations.

Comments on the respective notices are due on or before **January 20, 2015.**

## Proposed Disclosure Requirements

The FINRA RN 14-52 and the MSRB RN 2014-20 described proposed amendments to FINRA Rule 2332 (Customer Confirmations) and MSRB Rule G-15 (Confirmation, Clearance, Settlement and Other Uniform Practice Requirements with Respect to Transactions with Customer) to provide for enhanced disclosure requirements with respect to certain fixed-income securities transactions. More specifically, the proposal amendments would require a firm that executes a fixed-income transaction for a customer at or below a certain threshold size to disclose to customers on a transaction confirmation the difference in price to the customer against any other transaction effected by the firm in the same security on the same side as the customer (i.e., if both the customer and the firm bought or sold the same security on the same day). The following chart outlines the requirements of the proposed amendments.

1. FINRA, *Pricing Disclosure in the Fixed Income Markets*, Regulatory Notice 14-52 (Nov. 2014) (FINRA RN 14-52), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p601685.pdf, and MSRB, *Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations*, Regulatory Notice 2014-20 (Nov. 17, 2014) (MSRB RN 2017-20, collectively with the FINRA RN 14-52, the Notices), *available at* http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-20.ashx?n=1.

2. SEC, *Report on the Municipal Securities Market* (July 31, 2012) (Municipal Securities Report), *available at* http://www.sec.gov/news/studies/2012/munireport073112.pdf.

 

| | Proposed FINRA Rule 2232(b)(3) and (c) Amendments | Proposed MSRB Rule G-15(a)(i)(F) and (I) Amendments |
|---|---|---|
| **Security Type** | Corporate debt securities and agency debt-securities[3] | Municipal securities |
| **Customer Transaction Size** | ***Qualifying Size***—Transactions for the purchase or sale of 100 bonds or less or bonds with a face amount of $100,000 or less, based on reported quantities | Transactions where the broker, dealer, or municipal securities dealer is effecting a transaction as principal for 100 bonds or fewer or bonds in a par amount of $100,000 or less |
| **Transaction Types** | A sale to (purchase from) a customer of a ***Qualifying Size*** (see above) involving a corporate or agency debt security, where the member also executes a buy (sell) transaction(s) as principal with one party or multiple parties in the same security within the same trading day, where the size of the principal transaction(s) executed on the same trading day would meet or exceed the size of the customer transaction | ***Reference Transaction***—A transaction in which the broker, dealer, or municipal securities dealer transacts<br>1. in a principal capacity,<br>2. with a third party to purchase or sell municipal securities,<br>3. in the same security as the customer,<br>4. on the same side of the transaction as the customer (as purchaser or seller),<br>5. on the same date as the customer transaction, and<br>6. in a single-trade amount that equals or exceeds the size of the customer transaction, or in a trade amount that, when combined with one or more other transactions that meet the requirements of clauses (1) through (5) of this paragraph, equals or exceeds the size of the customer transaction |
| **Disclosure Requirement** | 1. The price to the firm<br>2. The price to the customer<br>3. The difference between the price to the firm and the price to the customer | 1. The price for any ***Reference Transaction*** (see above), and<br>2. The difference in the price between the reference transaction and the customer trade, expressed as a percentage of par |

## Disclosure Requirements in Practice

In its notice, FINRA provided 13 examples to illustrate how its proposed disclosure requirement would work in practice. We organized these examples as follows:

- **Firm Transactions Occurring Before or After Customer Transactions**
  - If a firm were to purchase bonds from another dealer in an amount that equals or exceeds a previous or subsequent same-day purchase by a customer or customers of the same bonds in a qualifying size, then the firm would have to disclose any price differentials to the customer or customers.[4] The same price differentials would have to be disclosed if the transactions were sales by the firm and its customer or customers.
    - In these scenarios, if a firm purchases 500 bonds at a price of $100 (i.e., $500,000 total) and later that day, five of the firm's customers each purchased 100 of these bonds at a price of $102, the price

3. *See* proposed FINRA Rule 2232(c)(1) and (2). Under the proposed rule, a "corporate debt security" would be defined as 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 [FINRA] Rule 6710(o) or an Asset-Backed Security as defined in [FINRA] Rule 6710(m)." An "agency debt security" would have the same meaning as a FINRA Rule 6710(m).

4. *See* Examples 1 through 4, FINRA RN 14-52 at 4.

differential would have to be disclosed to each customer (i.e., a firm price of $100, a customer price of $102, and a price differential of $2).

- **Customer Transactions That Exceed the Transaction Size Requirement**
  - If a customer were to purchase or sell bonds in an amount that exceeds the qualifying size, then a firm would not have a disclosure obligation.[5]
    - In this scenario, if a firm purchased 500 bonds at $100 and sold the entire lot to a customer at $102, the firm would not have a disclosure obligation because the transaction is above the qualifying size (i.e., the transaction is more than 100 bonds).
- **Purchase and Sale to Different Customers**
  - If a firm were to purchase bonds from one customer and subsequently sell the same bonds to another customer, and both transactions come within the qualifying size requirements, the firm would have to disclose the price differential to *both* customers.[6]
    - In this scenario, if a firm purchases 50 bonds from one customer at $98 and then sells 50 bonds to another customer at $102, the price differential would have to be disclosed.
- **Multiple Firm Trades That Equal the Size of the Customer Trade**
  - If, on the same day, a firm were to purchase bonds from multiple dealers at multiple prices, and those combined purchases are eventually sold to a customer in a qualifying size transaction, the firm would have disclose to the customer the price differential between the weighted average price to the firm of the bonds and the ultimate price to the customer.[7]
    - In this scenario, if a firm purchased 40 bonds from dealer A at $100 and 60 bonds from dealer B at $99, and then sold 100 bonds to a customer at $99.70, the weighted average price would be $99.40, and the price differential against the customer's price would have to be disclosed (i.e., $0.30).
- **Zero Price Differentials**[8]
  - In situations where there is no price differential in a qualifying size transaction (i.e., the price to the firm and the price to the customer are the same), a firm would still have to disclose both prices to the customer and indicate a zero price differential.
- **Multiple Firm Trades That Meet or Exceed the Size of the Customer Trade**
  - If a firm were to engage, as principal, in multiple same-day transactions that form the basis of its qualifying size transaction with a customer, but those transactions all meet or exceed the size of the transaction with the customer, FINRA would expect a firm to apply a "Last In, First Out" methodology to the transactions. More specifically, FINRA would expect a firm to refer to the last principal trade that preceded the customer trade for purposes of disclosing the price differential.[9]
    - In this scenario, if a firm (a) purchases 200 bonds from dealer A at 10:00 a.m. for $102.50, (b) purchases 100 bonds from dealer B at 10:30 a.m. for $104, (c) purchases 500 bonds from an institutional customer at 11:00 a.m. for $103.50, and (d) sells 100 bonds to a customer for $104.50, the firm would be required to disclose a price differential of $1.00 (i.e., a firm price of $103.5, a customer price of $104.5, and a price differential of $1).
  - Where a firm's sale to a customer is followed by multiple sales by the firm of the same security, FINRA would expect firms to refer to the transaction nearest in time to the customer's transaction when determining the price differential.[10]
    - In this scenario, if a firm (a) sells 100 bonds to a customer at 10:00 a.m. for $102, (b) buys 500 bonds from a dealer at 10:15 a.m. for $100, and (c) buys 200 bonds from a dealer at 10:30 a.m. for $101,

5. *See* Example 5, FINRA RN 14-52 at 5.
6. *See* Example 6, FINRA RN 14-52 at 5.
7. *See* Example 7, FINRA RN 14-52 at 5.
8. *See* Example 8, FINRA RN 14-52 at 6.
9. *See* Example 9, FINRA RN 14-52 at 6.
10. *See* Example 10, FINRA RN 14-52 at 6.

then the firm would have to disclose a price differential of $2 (i.e., a firm price of $100, a customer price of $102, and a price differential of $2).

- **Transactions Over Multiple Days**
  - Where a firm's transactions occurred on a day other than the day of a customer's transaction, those transactions do not have to be incorporated into the price differential calculation.[11]
    - In this scenario, if on day one, a firm purchases 50 bonds from a dealer for $100, and on day two, sells 50 bonds to a customer for $102, the firm would not have a disclosure obligation. If, however, a firm had purchased 50 bonds on day one for $100 and 50 bonds on day two for $99, the firm would have a disclosure obligation with respect to transactions on day two for a price differential of $3 (i.e., a firm price of $99, a customer price of $102, and a price differential of $3).
  - Where a firm engaged in multiple transactions over multiple days to equal the amount of a customer's qualifying size transaction, a price differential does not have to be disclosed if the firm transaction occurring on the same day as the customer transaction did not meet or exceed the size of the transaction to the customer.[12]
    - In this scenario, if on day one, a firm purchases 50 bonds for $100, and on day two, purchases 50 bonds for $101.50 and then sells 100 bonds to a customer for $102, the firm would not have a disclosure obligation because the firm's purchases on day two did not meet or exceed the size of the transaction to the customer.

## Observations

### Equity Principal Transactions

As an initial matter, it is worth mentioning that the proposed fixed-income disclosure requirements surpass the price differential disclosures currently required for equity securities under Rule 10b-10 of the Securities Exchange Act of 1934. More specifically, under Rule 10b-10(a)(2)(ii)(A), a broker-dealer only has to disclose a price differential to the customer on a transaction confirmation for an equity security if the transaction was effected on a riskless principal basis and the broker-dealer is not a market marker in the subject security.[13] For all other principal transactions in National Market System (NMS) stock (as defined in Rule 600 of Regulation NMS), Rule 10b-10(a)(2)(ii)(B) requires a broker-dealer to disclose a price differential if the price to the customer is different than the reported trade price. The proposed disclosure requirements go significantly beyond what is required under Rule 10b-10 in that the proposed price differential disclosures would apply to transactions in debt securities and could be triggered by any same-day transaction.

### Recommendations in Municipal Securities Report

Although FINRA and the MSRB refer to the municipal securities report as a basis for proceeding with the proposed disclosure requirement, the municipal securities report does not appear to be a recommendation of the sort that would necessitate the proposed disclosure requirements. Rather, with respect to price differentials on customer confirmations, the report only recommends that firms be required to disclose spreads on riskless principal transactions similar to the way that such spreads are disclosed for equity transactions under Rule 10b-10, as mentioned above.

11. *See* Examples 11 and 12, FINRA RN 14-52 at 7.

12. *See* Example 13, FINRA RN 14-52 at 7.

13. Under Exchange Act Rule 10b-10, a riskless principal transaction is described as a transaction in which a broker-dealer, after having received an order to buy from a customer, purchases the equity security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, sells the security to another person to offset a contemporaneous purchase from such customer.

 

### Costs to Change Confirmation Production and Delivery Systems

Perhaps the most significant impact that the proposed disclosure requirements will have is on the changes that firms will have to make to their front- and back-office systems. In this connection, firm systems will have to be reprogrammed to account for the different scenarios under which a price differential obligation could arise while taking into account the differences in disclosure obligations under Rule 10b-10. These system changes and related testing can be costly. For example, the last time the SEC evaluated the costs of changes to firms' systems in connection with transaction confirmations, it estimated that the industry costs of including additional disclosures on confirmations with respect to certain mutual fund distribution fees to be at about $285 million.[14] Although the costs of making back-office system changes to accommodate the proposed disclosure requirements would most likely be immediately borne by clearing firms that generate and send confirmations, these costs could be passed on to introducing firms that could, in turn, also pass these costs on to customers through account servicing and other related fees. Finally, it would appear that significant lead time would need to be provided to broker-dealers to permit them to meet these new requirements operationally.

## Conclusion

FINRA and the MSRB developed the proposed disclosure requirements to address concerns that fixed-income securities investors have limited information to assess and compare transaction costs and to increase transparency in the pricing of fixed-income securities transactions. Although FINRA and the MSRB take the view that additional pricing disclosures would provide investors with key information for each transaction and allow them to analyze the quality of services received by the firms, both organizations acknowledge the likelihood of financial and compliance burdens associated with system changes and data reporting to customers if the proposed disclosures are approved. As mentioned above, if approved, the proposed disclosure requirements could result in significant costs to firms as they make changes to their front- and back-office operations to account for the new disclosure requirements. In this connection, firms that would be affected by the proposed disclosure requirements may have a strong incentive to submit comments, and supporting data as appropriate, to FINRA and the MSRB in connection with firms' costs and associated compliance burdens. We will continue to review for developments in this area, especially in light of the interest in the municipal securities markets expressed by come SEC commissioners.[15]

## Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:


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14. Mutual Fund Distribution Fees; Confirmations, Exchange Act Release No. 62544 (July 21, 2010), 75 Fed. Reg. 47064, 47126 (Aug. 4, 2010).

15. *See*, *e.g.*, Kyle Glazier, *Gallagher: Focus on Pension Disclosure, Add More Muni Staff*, The Bond Buyer (Dec. 3, 2014) *available at* http://www.bondbuyer.com/news/washington-securities-law/gallagher-focus-on-pension-disclosure-add-more-muni-staff-1068412-1.html.

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