



UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

OFFICE OF THE  
INVESTOR ADVOCATE

December 11, 2015

**Submitted Electronically**

Ronald W. Smith  
Corporate Secretary  
Municipal Securities Rulemaking Board  
1900 Duke Street, Suite 600  
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Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
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**RE: MSRB Regulatory Notice 2015-16  
Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of  
Mark-ups for Specified Principal Transactions with Retail Customers**

**RE: FINRA Regulatory Notice 15-36  
Request for Comment on Revised Proposal Requiring Confirmation Disclosure of Pricing  
Information in Corporate and Agency Debt Securities Transactions**

Dear Mr. Smith and Ms. Asquith:

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), the Office of the Investor Advocate<sup>1</sup> at the U.S. Securities and Exchange Commission (“Commission” or “SEC”) is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations (“SROs”).<sup>2</sup> In furtherance of this objective, we routinely review significant rulemakings of the Municipal Securities Rulemaking Board (“MSRB” or the “Board”) and the Financial Industry Regulatory Authority (“FINRA”). We also make recommendations and utilize the public comment process to help ensure that the interests of investors are given appropriate weight as rules are being considered. As required by law, we report to Congress regarding our objectives and activities, which includes a summary of the recommendations we make and the responses to those recommendations.<sup>3</sup>

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<sup>1</sup> This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein.

<sup>2</sup> 15 U.S.C. § 78d(g)(4).

<sup>3</sup> 15 U.S.C. § 78d(g)(6).

As indicated in our Report on Objectives for Fiscal Year 2016, our Office is currently focused on municipal market structure and any corresponding reform initiatives that may impact investors.<sup>4</sup> Thus, we appreciate this opportunity to provide comments in regard to MSRB Regulatory Notice 2015-16, Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers (“MSRB Notice 2015-16”), and FINRA Regulatory Notice 15-36, Pricing Disclosure in the Fixed Income Markets (“FINRA Notice 15-36”).

## **I. Background**

Currently, broker-dealers are required to provide retail customers with confirmation statements following fixed income transactions, but they are under no regulatory obligation to include detailed pricing information on those trade confirmations. We are not aware of any regulatory barrier preventing firms from providing enhanced and effective pricing disclosures to their retail customers on a voluntary basis. Nevertheless, current industry practices only satisfy broker-dealers’ regulatory obligation to investors, and the resulting confirmation statements generally provide no more than the price that the customer paid or received for a fixed income security. Because industry practices have not addressed the longstanding problem of transaction transparency, retail investors remain disadvantaged by the lack of information they receive in confirmation statements. As a result, a regulatory solution appears necessary.

### Previous Proposals

Previously, the MSRB and FINRA requested comment on related draft rule proposals, MSRB Regulatory Notice 2014-20 and FINRA Regulatory Notice 14-52. These proposals generally were consistent with each other and were designed to work in tandem to provide retail investors with better price transparency in corporate and municipal bond transactions.

The draft amendments for MSRB Regulatory Notice 2014-20 would have “require[d] dealers to disclose on the customer confirmation the price to the dealer in a ‘reference transaction’ and the differential between the price to the customer and the price to the dealer for same-day, retail-size principal transactions.”<sup>5</sup> The MSRB defined the “reference transaction” as one in which the dealer purchases or sells the same security on the same date as the customer trade.<sup>6</sup> The proposed rule would have required dealers to “calculate and disclose the difference in price between a reference transaction disclosed on the confirmation and the price to the customer receiving the confirmation.”<sup>7</sup> The proposed disclosure requirement would have applied to transactions involving 100 or fewer bonds or bonds in a par amount of \$100,000 or less.<sup>8</sup>

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<sup>4</sup> See Office of the Investor Advocate, Report on Objectives for Fiscal Year 2016, June 30, 2015, <http://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2016.pdf>.

<sup>5</sup> MSRB, Regulatory Notice 2014-20, Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations, at 1 (Nov. 17, 2014), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2014-20.ashx?n=1>.

<sup>6</sup> *Id.* at 8.

<sup>7</sup> *Id.* at 8-9.

<sup>8</sup> *Id.* at 9.

The draft amendments for FINRA Regulatory Notice 14-52 took a very similar approach. FINRA proposed that “where a firm executes a sell (buy) transaction of ‘qualifying size’ with a customer and executes a buy (sell) transaction as principal with one or multiple parties in the same security within the same trading day, where the size of the customer transaction(s) would otherwise be satisfied by the size of one or more same-day principal transaction(s), confirmation disclosure would be required.”<sup>9</sup> FINRA’s proposal defined the term “qualifying size” as a transaction of 100 bonds or less or bonds with a face value of \$100,000 or less.<sup>10</sup> The proposed customer confirmation disclosure would have included the price to the customer, the price to the member of a transaction in the same security, and the differential between those two prices.<sup>11</sup>

We supported these steps of the MSRB and FINRA to improve the availability of pricing information and concurred, generally, with the goals underlying both MSRB Regulatory Notice 2014-20 and FINRA Regulatory Notice 14-52.<sup>12</sup> We encouraged the MSRB and FINRA to adopt their respective proposed amendments because we believe that retail investors would benefit from the inclusion of additional pricing transparency on their customer confirmations.<sup>13</sup> We indicated that disclosing the same-day price reference information would provide retail investors with more effective tools to evaluate their transactions and the quality of service provided.<sup>14</sup> However, after receiving public comment, the MSRB and FINRA issued revised proposals instead of adopting the rules as proposed.

### Current Proposals

FINRA Regulatory Notice 15-36 retains the same basic approach as the prior FINRA proposal. If a firm sells to a customer as principal on the same day it buys the security from another party, the firm would be required to disclose on the customer confirmation the price to the customer, the price to the firm of a same-day trade (reference price), and the difference between the two prices.<sup>15</sup> However, the disclosure requirement would now only apply to bond trades on behalf of non-institutional accounts, no matter the size of the trade.<sup>16</sup> In addition, FINRA’s new proposal would allow for alternative calculation methods for more complex trade scenarios and would permit member firms to provide clarifying information when there has been a material change to the price of a security between the reference transaction and the customer transaction.<sup>17</sup> It also would require member firms to include a hyperlink to relevant Trade Reporting and Compliance Engine (TRACE) data on the customer confirmation.<sup>18</sup>

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<sup>9</sup> FINRA, Regulatory Notice 14-52, Pricing Disclosure in the Fixed Income Markets, at 3 (Nov. 17, 2014), [http://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_14-52.pdf](http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 1.

<sup>12</sup> See Comment Letter, Rick A. Fleming, Investor Advocate, SEC, *RE: MSRB Regulatory Notice 2014-20, Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations* (Jan. 20, 2015), <http://www.msrb.org/RFC/2014-20/USSEC.pdf>; see Comment Letter, Rick A. Fleming, Investor Advocate, SEC, *RE: FINRA Regulatory Notice 14-52, Request for Comment on Pricing Disclosure in the Fixed Income Markets* (Jan. 20, 2015), [http://www.finra.org/sites/default/files/notice\\_comment\\_file\\_ref/SEC.pdf](http://www.finra.org/sites/default/files/notice_comment_file_ref/SEC.pdf).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> FINRA, Regulatory Notice 15-36, Pricing Disclosure in the Fixed Income Markets, at 1 (Oct. 12, 2015), [http://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-15-36.pdf](http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-36.pdf).

<sup>16</sup> *Id.* at 3. As noted above, qualifying size was defined as 100 bonds or less, or face value of \$100,000 or less.

<sup>17</sup> *Id.* at 3-4.

<sup>18</sup> *Id.* at 5.

In contrast, MSRB Regulatory Notice 2015-16 takes a significantly different approach from the earlier MSRB Regulatory Notice 2014-20. The new proposal would require customer confirmations to disclose the “mark-up” for principal transactions when the dealer transacts in a municipal security in a specified trade size on the same side of the market as the customer.<sup>19</sup> Under the proposed new calculation, the security’s mark-up would be the difference between the price to the customer and the “prevailing market price” for the security at the time of the customer’s transaction.<sup>20</sup> Moreover, under the proposed amendment, the dealer’s responsibility to disclose the mark-up would be triggered only when the dealer engaged in its own same-side transaction within two hours of the customer transaction.<sup>21</sup> Transactions occurring the same day but outside of that two-hour window would not be subject to mandatory pricing disclosure.<sup>22</sup>

In addition, the new MSRB proposal would incorporate changes similar to those in the new FINRA proposal. For example, MSRB Regulatory Notice 2015-16 would require mark-up disclosure for “non-institutional” account transactions, which is already defined within the MSRB rules, as opposed to transactions of a certain size.<sup>23</sup> Further, it requires dealers to disclose a hyperlink and URL address to the “Security Details” page for the customer’s security on the MSRB’s Electronic Municipal Market Access (EMMA) service, along with a brief description of the type of information available on that page.<sup>24</sup>

FINRA and the MSRB both propose new exceptions to the required pricing disclosure. Neither would require disclosure of reference pricing in transactions related to offerings of new issues.<sup>25</sup> Additionally, each would provide exceptions for certain transactions involving functionally separate trading desks.<sup>26</sup>

## II. Evaluation

As an initial matter, we believe investors would be poorly served by pricing disclosures that are different for corporate bonds as compared to municipal bonds. To avoid investor confusion, it is important for FINRA and the MSRB to adopt consistent rules related to confirmation disclosure. Toward that end, we submit this single comment letter in response to both proposals, and we suggest which of the competing ideas should be adopted by both MSRB and FINRA.

### Timeframe

As noted above, FINRA proposes to require disclosure when the initial and subsequent transactions occur on the same trading day.<sup>27</sup> The MSRB, however, has proposed to shorten the relevant

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<sup>19</sup> MSRB, Regulatory Notice 2015-16, Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers, at 1 (Sept. 24, 2015), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-16.ashx?n=1>.

<sup>20</sup> *Id.* at 8.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 9 n.25; *see also* MSRB Rule G-8(a)(xi) (defines institutional account).

<sup>24</sup> *Id.* at 12.

<sup>25</sup> *Id.* at 9-10. *See supra* note 15, at 3; *see supra* note 19, at 10.

<sup>26</sup> *See supra* note 15, at 3; *see supra* note 20, at 11.

<sup>27</sup> *Supra* note 15, at 2.

window of time to two hours on either side of the customer trade.<sup>28</sup> According to the MSRB, its revised window would still require mark-up disclosure for at least half of all retail-sized customer trades in the secondary market.<sup>29</sup>

We strongly oppose the proposed two-hour window. We believe the minimum window of time for disclosure should be the full trading day. Although dealers often trade within two hours under existing rules, dealers could easily adjust their behavior to avoid the new disclosure requirements by trading a few minutes outside of the proposed two hour window. Therefore, current trading behavior is not necessarily indicative of trading behavior that will occur if the revised proposal is implemented.

Disclosure avoidance would be much more difficult under the timeframe in the FINRA proposal, which requires disclosure for transactions occurring on the same trading day. A dealer takes on much greater balance sheet risk by holding inventory overnight, which would deter dealers from separating transactions in order to avoid disclosure. Thus, we encourage the MSRB to forgo the proposed two-hour window. At a minimum, both FINRA and the MSRB should require pricing disclosure for transactions occurring within the same trading day.

### Mark-Up vs. Reference Price

Although we oppose the MSRB's proposal to shorten the relevant trading window to two hours, we support moving forward with mark-up disclosure as described in the new MSRB proposal. Initially, we supported the MSRB's original proposal for price reference disclosure because it was a significant improvement over the *status quo*. In addition, the price reference proposal appeared to have the advantage of simplicity, meaning that the required disclosures would be relatively easy for dealers to ascertain. For similar reasons, we supported the original FINRA proposal for price reference disclosure.

From the investor perspective, however, there are advantages to the new MSRB mark-up proposal. Admittedly, it may lead to disclosure of a smaller cost to investors under certain circumstances. For example, if a dealer purchases a security and there is a significant positive market move prior to the resale to a retail customer, the amount of the mark-up would only be the difference between the price of the resale and the "prevailing market price" at the time of the resale, instead of the full difference between the original purchase and the subsequent resale. However, the MSRB proposal provides investors with the relevant information about the actual compensation the investor is paying the dealer for the transaction. It reflects market conditions and has the potential to provide a more accurate benchmark for calculating transaction costs.<sup>30</sup>

Importantly, we note also that the calculation of a true mark-up, once established under these rules, need not be limited to a single trading day. After the systems are in place for disclosing mark-ups on same-day transactions, dealers may decide for competitive reasons to disclose mark-ups on all transactions. Moreover, FINRA and the MSRB could choose to require disclosure beyond the one day window after assessing the implementation of the new rules. In contrast, a price reference disclosure model does not account for intervening market events that affect the value of the bond during the lag between the reference transaction and the customer transaction, so the disclosure becomes less

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<sup>28</sup> *Supra* note 19, at 8.

<sup>29</sup> *Supra* note 19, at 8 n.22.

<sup>30</sup> It is our understanding that the process for calculating mark-up under the MSRB revised proposal may build upon existing systems. To that end, it may be easier for industry to implement disclosure under the MSRB's revised proposal.

meaningful as the window for disclosure increases. Thus, for disclosure of pricing information beyond a one day window, a mark-up model could serve as a better framework than a price reference model.

Although we support a move to disclosure of a mark-up that is based upon a prevailing market price, we are concerned with potential manipulation of the prevailing market price calculation. Errors in the calculation, whether intentional or not, could significantly alter the information provided to investors. With this in mind, we encourage the MSRB and FINRA to monitor carefully the industry's implementation of the rules to ensure that dealers appropriately determine the prevailing market price.

The MSRB proposes to express the mark-up as both a total dollar amount and percentage of the principal amount of the customer transaction. FINRA's proposal would disclose a differential only as a numeral. We believe that disclosing a mark-up as a total dollar amount and a percentage would more effectively enable retail investors to evaluate their transaction costs and monitor the quality of service provided by dealers. Thus, we support the MSRB approach.

### Functionally Separate Trading Desk Exception

Both the MSRB and FINRA revised proposals include an exception for transactions involving "functionally separate" trading desks. Although we do not oppose an exception of this nature, both proposals could be strengthened by incorporating greater precision or guidance relating to the meaning of "functionally separate." For example, would FINRA anticipate applying similar standards to those that it currently employs when evaluating whether broker-dealer self-trades are *bona fide* or fraudulent "wash sales" under Supplementary Material .02 to FINRA Rule 5210, or does FINRA believe that a different standard would be appropriate here?<sup>31</sup> To avoid the possibility of such an exception becoming a loophole or blanket exception, we strongly encourage both the MSRB and FINRA to provide robust guidance surrounding the meaning and requirements concerning functionally separate trading desks.

We also believe the final rules should incorporate the strongest features of both proposals. Thus, at a minimum, a 'functionally separate' trading desk exception should require that the trading desks through which transactions are made have no knowledge of the customer transaction and that the transactions and positions of the separate desk must not regularly be used to source retail transactions at the other desk.

### **III. Conclusion**

We appreciate the MSRB's and FINRA's acknowledgement of the information disparity inherent in fixed income market transactions, and we support your corresponding efforts to address retail customers' information disadvantage by increasing price transparency and the availability of pricing information. While we regard both proposals as improvements upon the *status quo*, we believe that combining the MSRB's mark-up disclosure methodology with FINRA's same day window would best serve the interest of investors. We also believe that the rules must be enforced rigorously to prevent manipulation of the information provided to investors.

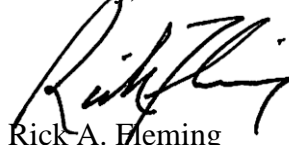
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<sup>31</sup> See Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to Self-Trades and FINRA Rule 5210, Exchange Act Release No. 34-72067 (May 1, 2014) [79 FR 26293 (May 7, 2014)], at n.12 ("Transactions that originate from unrelated algorithms or from separate or distinct trading strategies, trading desks, or aggregation units that are frequent or numerous may raise a presumption that such transactions were undertaken with the intent that they cross and may, therefore, be intended as manipulative or fraudulent.").

Such changes could have a significant impact on the behavior of dealers and individual investors. Individual investors engaged in retail-size trades will be better equipped to evaluate the transaction costs and the quality of service provided to them by their dealers. This, in turn, should promote competition and improve market efficiency among dealers. The changes will help ensure that the prices and markups are appropriate in light of the market for the particular security.<sup>32</sup>

Should you have any questions, please do not hesitate to contact me or Senior Counsel Ashlee Connett at (202) 551-3302.

Sincerely,



Rick A. Fleming  
Investor Advocate

cc (electronically): Lynnette Kelly, Executive Director, MSRB  
Robert Fippinger, Chief Legal Officer, MSRB  
Michael Post, General Counsel – Regulatory Affairs, MSRB  
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<sup>32</sup> *Supra* note 5, at 7.