Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS MARCH 11, 2011

FINRA Proposes Rules Governing Markups, Markdowns, Commissions, and Fees

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently proposed revised consolidated FINRA rules governing markups, markdowns, commissions, and fees. The rule proposal includes the most significant changes with respect to markups in many years. The proposed changes would consolidate and materially revise several NASD and NYSE rules. The FINRA Notice proposing these rule changes is available at http://www.finra.org/notices/11-08. FINRA is accepting comments on the proposal until March 28, 2011.

Key Issues

FINRA proposes to incorporate NASD Rule 2440, NASD IM-2440-1, and NYSE Rule 375 as new FINRA Rule 2121 (Fair Prices and Markups, Markdowns, and Commissions), subject to significant changes. Among other things, FINRA proposes to eliminate the "5% policy" and the "proceeds provision" in NASD Rule IM-2440-1. FINRA also proposes to require firms to provide commission schedules for equity securities to retail customers and to notify and obtain consent from a customer to charge a commission when a firm misses the market and trades with the customer on a principal basis.

FINRA also proposes to incorporate the requirements set forth in NASD IM-2440-2 in new FINRA Rule 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities), without significant change. FINRA proposes not to incorporate the substantive provisions of NYSE Rule Interpretation 375/01 (Customer Contact and "As of" Reports), which addresses the execution price of orders where a member has missed the market.

Finally, FINRA proposes to transfer NASD Rule 2430 to new FINRA Rule 2123 (Charges and Fees for Services Performed) and to require members to provide retail customers with schedule(s) of charges and fees for services.

Proposed FINRA Rule 2121—Fair Prices and Markups, Markdowns, and Commissions

Fair and Reasonable Markups, Markdowns and Commissions. Proposed FINRA Rule 2121 would generally incorporate the requirements of NASD Rule 2440 with only minor changes. That rule generally requires that securities be sold to or purchased from customers at fair and reasonable prices and be subject to fair and reasonable commissions where a firm is acting as an agent. The new rule would modify a provision regarding a member engaged in a principal transaction to clarify that when member engages in a principal transaction, although members may set customer transaction charges that are profitable to the firm, the markups, markdowns, and commissions charged by a member must be established in line with the considerations set forth in the rule. For example, a member that charges a fixed commission of $20 per transaction generally would be entitled to charge this same commission for a purchase transaction of 20 shares of a security at an execution price of $2, but a firm's right to set profitable transaction charges would not be viewed by FINRA as a license to set high minimum markup, markdown, or commission charges nor allow a firm to factor into such charges realized and unrealized market losses on securities that the firm holds or has held in inventory.

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Elimination of the 5% Policy. Current NASD IM-2440-1 provides that the question of whether markups or spreads are fair is one for which no definitive answer can be given and no interpretation can be all-inclusive for the reason that what might be considered fair in one transaction could be unfair in another transaction because of different circumstances. Dating back to 1943, a "5% policy" has been applied that generally suggests that in most transactions executed for customers, markups of 5% or less would be within the "fair and reasonable" standard of NASD Rule 2440. Current NASD IM-2440-1 provides that the "5% policy" is a guide and not a rule, and that a markup pattern of 5% or even less might, in certain circumstances, be considered unfair or unreasonable.

The proposed consolidations would not transfer the "5% policy" to proposed FINRA Rule 2121. FINRA believes that the policy establishes a presumption that markups, markdowns, and commissions in excess of 5% are prohibited or subject to additional scrutiny, requiring a firm to provide more justification to prove that such remuneration is not "excessive". Conversely, FINRA notes that the policy is also viewed by many as establishing a specific ceiling or cap below which most markups, markdowns, or commissions will not be viewed as excessive. As a result of these and other reasons, FINRA believes that the "5% policy" is outdated and should be eliminated. FINRA emphasizes, however, that the elimination of the policy would not be an opportunity to increase markups, markdowns, and commissions, but instead reflects FINRA's determination that the "5% policy" does not reflect current industry practices. The decision to delete the "5% policy" also reflects FINRA's view that a member must use the factors in proposed FINRA Rule 2121(c) to assess its remuneration for execution of customer transactions. The new rule would provide seven non-exclusive factors that a firm should consider in determining whether a markup, markdown or commission is fair and reasonable:

- type of security involved,
- availability of the security in the market,
- price of the security,
- amount of money involved in a transaction,
- disclosure,
- pattern of markups, and
- nature of the firm's business.

Elimination of the Proceeds Provision. Under the "proceeds provision" of NASD IM-2440-1(c)(5), when a customer sells one security and buys a second security at the same time using the proceeds of the sale, both trades are required to be treated as a single transaction for markup, markdown, or commission purposes. This means that the total remuneration for both transactions would generally not be allowed to exceed the remuneration amount for a single transaction. Among other issues, it is not always clear when two transactions occurring close in time are related or how close in time transactions must be to be considered "proceeds" transactions under the current rule. FINRA believes the more rational approach is that transaction remuneration be determined on a fair basis pertaining to each transaction.

Excluded Transactions. Proposed FINRA Rule 2121(d) generally incorporates current exclusions that provide that the markup rule would not apply to (a) the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price or (b) a transaction with a qualified institutional buyer ("QIB") that meets the conditions of proposed FINRA Rule 2122(b)(9).

Commission Schedules for Equity Securities Transactions. Proposed FINRA Rule 2121(e) would require firms to establish and make available to retail customers schedules of standard commission charges for equity securities transactions. A firm would be allowed to have multiple schedules of standard commission charges so long as it discloses how the commissions are applied among all retail customers. A firm would be required to provide the schedules of commissions to new retail customers in writing at the opening of an account and to all retail customers at least once each year. Amendments to the schedules would be required to be delivered in writing to all retail customers at least 30 days prior to imposing any change in the commissions or any new forms of commission charges or disclosures for retail customers. A firm would be permitted to post its schedules of standard commission charges on its website as an alternative to actual delivery if the firm provides written notice to new retail customers at the opening of an account and to all retail customers at least once every calendar year of the manner in which they may access the commission schedules, and that a written copy is available on request. A firm would still be required to provide written notice to all retail customers at least 30 days prior to imposing any change in the commissions set forth in the schedules or any new forms of commission charges for retail customers.

Notice of Missing the Market and Consent to Commission Charge. NYSE Rule 375 currently prohibits a member from charging a customer a commission without the customer's knowledge and consent if the member has accepted the order for execution and, by neglecting to execute the order or otherwise, takes or supplies for its own account the securities named in the order. FINRA proposes to transfer these requirements to proposed FINRA Rule 2121. This rule would be a new requirement for former NASD-only members.

Proposed FINRA Rule 2122—Markups and Markdowns for Debt Securities Transactions

Proposed FINRA Rule 2122 would largely mirror current NASD IM-2440-2 and would generally contain:

- the standards for determining a markup or a markdown in a transaction with a customer in a debt security other than a municipal security,
- the procedures to identify prevailing market price,
- the role of the dealer's contemporaneous cost in determining prevailing market price,
- the characteristics of "similar securities",
- the role of similar securities in determining a markup or a markdown, and
- an exemption for certain transactions in non-investment grade securities effected with certain QIBs.

Proposed FINRA Rule 2123—Charges/Fees for Services

Proposed FINRA Rule 2123 would restate the current NASD Rule 2430 requirement that charges and fees for services must be reasonable and not unfairly discriminate among customers. The rule would apply to all charges and fees for services provided by a firm that are not related to the execution of a transaction. Firms would be required to establish and make available to retail customers their schedules of standard charges and fees and disclosure requirements similar to those described above for commissions would also apply to charges and fees for non-execution services.

Other Issues

NYSE Rule Interpretation 375/01. FINRA proposes not to incorporate NYSE Rule Interpretation 375/01 relating to the execution price of orders where a firm has "missed the market" as a result of obligations under two existing NASD rules. NASD Rule 2320 (proposed to be replaced with FINRA Rule 5310) requires that a firm execute a customer order in the best market for that security "so that the resultant price to the customer is as favorable as possible under prevailing market conditions". In addition, NASD Rule 2111 (proposed to be replaced with FINRA Rule 5320) requires a firm to "make every effort to execute a customer market order that it receives fully and promptly".

Market Makers. As is the case with the current markup rules, the proposed rules do not address a market maker's allowance, subject to the limitations in regulation, to capture the trading spread between the bid and the ask prices. FINRA has stated that nothing in the proposed markup rules affects that body of law and regulation.

Submitting Comments to FINRA

You may submit comments to FINRA on the proposed amendments on or prior to March 28, 2011, by hard copy or by emailing comments to pubcom@finra.org. Before becoming effective, a proposed rule change must be authorized by the FINRA Board of Governors and then must be approved by the Securities and Exchange Commission following publication for public comment.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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