

## FINRA Requests Comment on Proposed Rules Governing Markups, Commissions and Fees

February 15, 2013

On January 31, 2013, the Financial Industry Regulatory Authority (“**FINRA**”) issued a **Regulatory Notice** requesting comment on new **proposed FINRA rules** governing markups, markdowns, commissions and other fees. FINRA’s proposal would transfer several existing NASD rules and interpretations and a New York Stock Exchange (“**NYSE**”) rule to the FINRA rulebook, while making several substantive changes. The proposal is similar to a **2011 FINRA proposal** to revise the markup rules (the “**2011 Proposal**”). However, in response to comments received, FINRA abandoned the 2011 Proposal’s plan to eliminate FINRA’s long-standing “5% Policy” for markups and made a number of other substantive changes.

FINRA has requested comments on the proposal by April 1, 2013, though the proposed rule changes would not become effective until filed with and approved by the SEC following a second comment period.

### Fair Prices and Markups, Markdowns and Commissions

Proposed FINRA Rule 2121(a) would generally maintain the requirements of current **NASD Rule 2440**. The proposed rule would provide that in any securities transaction where a FINRA member acts as principal with a customer, the member must buy or sell at a fair and reasonable price, taking into consideration all relevant facts and circumstances. In addition, a member acting as agent for its customer would be prohibited from charging its customer more than a fair and reasonable commission, fee or service charge.

Proposed FINRA Rule 2121 would not apply to: (1) 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 (2) a transaction in a non-investment grade debt security with a qualified institutional buyer (“**QIB**”) that meets certain conditions under proposed FINRA Rule 2122, which is described below.

### Retaining the “5% Policy,” With Slight Adjustments

Under current **NASD IM-2440-1**, whether a markup is “fair and reasonable” or “excessive” depends upon an evaluation of a number of factors surrounding the transaction. However, FINRA’s “5% Policy” has long provided guidance that, in most transactions, markups of five percent or more would be considered excessive, but that an even lower markup could run afoul of the “fair and reasonable” standard in some cases.

In its 2011 Proposal, FINRA proposed to eliminate the 5% Policy, citing its belief that the 5% Policy is outdated and does not reflect current market conditions. Many commenters opposed the removal of the 5% Policy, arguing, among other things, that it helps firms establish effective supervisory and compliance procedures.

In response to comments, FINRA now proposes to retain the 5% Policy. Consistent with the general considerations in NASD IM-2440-1, proposed FINRA Rule 2121(b)(1) would provide that the 5% Policy is a guide, not a rule, and that even a markup pattern of five percent or less may be considered unfair or unreasonable in various circumstances. FINRA’s proposal would explicitly create a rebuttable presumption that a markup, markdown or commission in excess of five percent is unfair and

unreasonable. This presumption could be overcome by a demonstration that the markup, markdown or commission is fair and reasonable based on the relevant factors described further below.

### **General Considerations for Determining if a Markup, Markdown or Commission is Fair and Reasonable**

Proposed FINRA Rule 2121 would also retain the same basic considerations for determining the fairness and reasonableness of a markup, markdown or commission as currently provided in NASD IM-2440-1, subject to minor changes. In general:

- a member may consider its expenses, but may not justify markups, markdowns or commissions based on excessive expenses;
- the amount or percentage to be considered when determining if a member firm has dealt fairly with a customer in a principal transaction is the difference between the customer's price (including the markup or markdown) and the prevailing market price (which, unless other bona fide, more credible evidence of the market can be evidenced, is indicated by the member's contemporaneous cost or proceeds);
- if a member firm sells a security to a customer from inventory (except in riskless principal trades or trades in which a security is briefly held in a member's inventory), the amount of the markup would be determined on the basis of the markup over the bona fide representative current market price; and
- the determination of the fairness of a markup, markdown or commission must be based on all relevant factors, as described below.

FINRA notes that, like the current markup rules, proposed FINRA Rule 2121 and proposed FINRA Rule 2122 (discussed below) do not address a market maker's ability to capture trading spreads and do not affect the body of law and regulation regarding market maker spreads.

### **Relevant Factors for Determining if a Markup, Markdown or Commission is Fair and Reasonable**

FINRA proposes to transfer the list of seven non-exclusive factors for determining if a markup, markdown or commission is fair and reasonable from NASD IM-2440-1 to proposed FINRA Rule 2121 -- *i.e.*, the type of security involved; the availability of the security in the market; the price of the security; the amount of money involved in a transaction; disclosure; the pattern of markups; and the nature of the member's business. However, the proposal would refine these factors in various respects, including the following:

- under the "availability of the security in the market" factor, the effort and cost of buying or selling the security may be a factor when a security is difficult to locate, is traded infrequently, is subject to market liquidity constraints or there are unusual circumstances connected with a security's acquisition or sale (*e.g.*, the security is acquired through a foreign intermediary);
- under the "amount of money involved in a transaction" factor, a lower percentage of markup, markdown or commission may be warranted for a transaction that involves a large amount of money where the expenses of handling the transaction do not rise by virtue of the size of the transaction; and
- under the "disclosure" factor, for disclosure to be considered in determining if a member deals fairly with a customer, the member must, before the transaction is effected, disclose the total dollar amount and percentage of the commission charged in an agency transaction, or the total dollar amount and percentage markup or markdown in a principal transaction.

## Elimination of the “Proceeds Provision”

FINRA proposes to eliminate a current requirement that when a customer sells one security and buys a second security at the same time, using the proceeds of the securities position liquidated to pay for the second position, both trades must be treated as a single transaction for markup, markdown and commission purposes. Under the current rule, the total remuneration for both transactions would generally not be allowed to exceed the remuneration amount for a single transaction. FINRA proposes to eliminate this requirement since it can be difficult to apply consistently, and determining fair remuneration for each transaction is more practical.

## Markups and Markdowns in Debt Securities

FINRA proposes to transfer the elements of [NASD IM-2440-2](#) dealing with markups and markdowns in debt securities to proposed FINRA Rule 2122, largely in the same form. Similar to the current rule, proposed FINRA Rule 2122 would not apply to transactions in municipal securities, although it would now apply to transactions in government securities other than U.S. Treasury securities.

Currently, under NASD IM-2440-2, member firms engaged in customer transactions that meet the following conditions are not subject to the requirements governing markups and markdowns for transactions in debt securities: (1) the transaction is effected with a QIB; (2) the transaction involves a non-investment grade debt security; and (3) the dealer has determined, after considering certain specified factors, that the QIB has the capacity to evaluate independently the investment risk and, in fact, is exercising independent judgment in deciding to enter into the transaction. FINRA proposes to revise the third criterion to require that a dealer have a reasonable basis to believe that the QIB is capable of evaluating investment risk independently, both in general and with regard to particular transactions and investment strategies involving a security or securities. The revised criterion would also require the QIB to affirmatively indicate that it is exercising independent judgment in deciding to enter into the transaction.

## Charges and Fees for Services Performed

FINRA also proposes to retain its current rule which provides that charges and fees for services must be reasonable and not unfairly discriminatory among customers. However, FINRA proposes to add a requirement that member firms establish and make available to retail customers their schedules of standard charges and fees for miscellaneous services such as research, appraisals, custody of securities and setting up new accounts. If a member firm negotiates or intends to negotiate reduced charges or fees below what is provided in the applicable schedules, the firm would be required to disclose that it may charge certain retail customers charges and fees that are lower than the charges and fees contained in the schedules.

In addition, a member firm would be required to provide written notice to all retail customers at least 30 days prior to the effectiveness of any changes in a charge, fee or other information provided in the schedule. A member would be able to satisfy the requirement to provide schedules of charges and fees for services performed to retail customers by making the schedules available on its website as long as retail customers receive written or electronic notice of its availability at account opening and at least annually thereafter.

## Notice of Missing the Market and Consent to Commission Charge

FINRA proposes to eliminate [NYSE Rule 375](#) and incorporate into proposed FINRA Rule 2121 a requirement that a member firm must provide notice to its customer before charging the customer a commission when it “misses the market.” In particular, the rule would prohibit a member firm that accepts an order for execution as agent and, by reason of neglect to execute the order or otherwise, trades with the customer as principal, from charging the customer a commission, without the customer’s knowledge and consent.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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