

FINANCIAL INFORMATION FORUM

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Via Electronic Delivery

December 11, 2015

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: MSRB Notice 2015-16 - Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers; FINRA Notice 15-36 - FINRA Requests Comment on a Revised Proposal Requiring Confirmation Disclosure of Pricing Information in Corporate and Agency Debt Securities Transactions.

Dear Mr. Smith and Ms. Asquith,

The Financial Information Forum (FIF)¹ would like to take this opportunity to comment on MSRB Notice 2015-16 and FINRA Notice 15-36 (“Proposals”). The FIF Back Office Committee (“FIF”) has reviewed the proposals from an implementation perspective. We understand the intent of the proposals is to provide retail investors with insight and transparency into transaction costs and dealer compensation associated with their trades. We believe these proposals create significant implementation challenges to all dealers of municipal, corporate and agency debt securities, and may cause unintended consequences. FIF’s comments on both proposals are limited to considerations related to implementation of the alternatives outlined in each of the proposals, and do not address policy issues. *This letter should not be interpreted as an endorsement or recommendation for either a mark-up or reference price on retail customer confirmations.*

Alignment of MSRB and FINRA is Imperative

As noted in our previous Comment Letter², FIF members reiterate the request for MSRB and FINRA to take a coordinated approach in their rule making and requirements on this initiative. While the intent of

¹ FIF (www.fif.com) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the securities industry across the order lifecycle. Our participants include trading and back office service bureaus, broker-dealers, market data vendors and exchanges. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

² [FIF Comment Letter on MSRB Notice 2014-20 and FINRA Notice 14-52](#); submitted January 20, 2015.

these new proposals is similar, to provide added transparency to retail³ customers through additional disclosure on the customer confirmation, there are significant differences between the most recent MSRB proposal to require mark-up information and the FINRA proposal to require dealers to provide reference pricing. The obvious differences include: the timeframe for triggering disclosure (MSRB's two hour window vs. FINRA's same trading day), data required to be disclosed on the confirmation (dealer mark-up on prevailing market price expressed as a percentage vs. differential between price to the customer and the member's reference price.) Each of these approaches will vary in implementation costs and ongoing operational costs.

Additionally, while we prefer to limit the scope of this disclosure to address only "riskless" principal trades, if the regulators intend to broaden the scope of the requirements in the future (for example, expand the focus from riskless principal to include all principal trades), FIF members wish to avoid a double build-out and would prefer that all requirements be addressed within the same initiative. From an implementation perspective, incremental steps result in increased costs.

FIF members urge MSRB and FINRA to be fully harmonized in any resulting regulations, as we expect that costs would increase exponentially if there are significant variations between MSRB and FINRA rules, as well as extended lead times for implementation.

Limited Resources

It is important to understand that in most cases, the same resources within a firm are responsible to effect the necessary changes in both the TRACE and the MSRB data capture and confirmation processes. Implementation of T+2 for corporate and municipal bonds will rely largely on the same skilled and knowledgeable subject matter experts to conduct the analysis, and make and test the operational and technical changes. We urge the regulators to consider the burden placed on these finite resources, given the array of regulatory initiatives planned for 2016 and 2017.⁴

While neither FINRA nor the MSRB have provided timeframes for implementation of these new disclosure requirements, overlapping timeframes with the industry's preparations for T+2 settlement must be avoided. Chair White has registered her strong support for T+2 requesting that SROs finalize schedules of rule changes such that the industry could complete its work no later than the third quarter of 2017. Accordingly, MSRB has committed to adopt rule changes by Q2 2016 to meet the targeted completion date. The many initiatives involved to reach T+2 will be resource intensive and costly. Whatever approach is agreed by the regulators to address confirmation disclosure, we request that the effective dates be scheduled to allow sufficient time for implementation after T+2 has been completed.

Significant Implementation Challenges

In addition to urging that regulators develop an implementation timeline with due consideration being given to T+2 and other regulatory initiatives that will draw upon the same finite resources, FIF has identified the following implementation challenges with the FINRA and MSRB proposals that it believes should be addressed in any final proposal submitted to the Commission for approval.

³ FIF members appreciate the consistent approach proposed by both MSRB and FINRA to identify retail customers as those that are "not institutional" as defined by MSRB G-8 or FINRA 4512(c), or not a proprietary account. Inclusion of institutional accounts under these proposals would cause serious disruption to the automated confirmation process (e.g. Omgeo).

⁴ Several TRACE and MSRB changes are in progress and must be completed by May 23, 2016. Most recently, additional changes to TRACE have been proposed by FINRA for implementation July 18, 2016. Pending adoption of T+2 rule changes in Q2 2016, work must start immediately following current initiatives to meet a Q3 2017 target for T+2.

Straight Through Processing Disruptions

Using the full trading day window to determine if a trade was done risklessly will negatively impact straight-through processing in those firms that currently produce customer confirmations at the time of the trade. There has been a concerted effort in recent years to streamline and automate, and this requirement will break the process that has taken years to achieve.

- Dealers will need to hold up generating a retail trade confirmation to identify any possible related principal (inter-dealer) trades in the same security, on the same side. Principal transactions may have been executed either before or after the customer trade, or both. In any case, a process must be developed to capture trades that are potentially related and to identify specifically which trades should be applied to the calculation to be included on the confirmation. Manual intervention may be required to ensure the appropriate trades are selected; that is, that the principal trades identified are those most closely aligned to the riskless trade and representative of the prevailing market.
- If the same-day trading window is ultimately used in any resulting requirements, limiting the search to principal trades that *preceded* the customer trade would be preferable. Although this does not eliminate the potential need for manual intervention, it would not require the confirmation process to be deferred until end-of-day.
- There are firms that generally use a batch cycle to produce “retail” confirms, but leverage the real-time “institutional ID” process⁵ to generate confirms for their high net worth clients who utilize third party custodians, for example. The need to place the added information on the ID confirmation for these clients would seriously disrupt the process and cause widespread consequences. While a follow-up paper confirmation could be produced for these high net worth individuals, in all likelihood, neither the investor nor the custodian wants to manage the paperwork.

Leveraging TRACE/MSRB Reference Prices

There are pros and cons to utilizing a reference price made available by FINRA or MSRB, as discussed in the proposals. Some uniform set of business rules would need to be established to determine exactly the criteria for identifying which trades should be included in the reference price calculations.

- Pros
 - For firms utilizing a batch process, this would be straightforward to implement; assuming an end-of-day feed were made available by MSRB and FINRA prior to 6PM (ET), this would allow most firms time to include the information in their confirmation processes.
 - This would eliminate the need for each firm to build the “matching engine” required to identify transactions representing contemporaneous cost or related principal transaction(s).
 - This would reduce the significant burden and expense on smaller firms, particularly those that rely on third-parties for clearing and/or transaction processing.⁶
 - This approach would provide consistent reference pricing across the industry.
 - Customers would have confidence in market transparency if the prevailing market or reference prices were obtained from FINRA or MSRB.

⁵ See Footnote 3.

⁶ Some third-party firms such as clearing firms and other service providers have indicated they will not take responsibility, for both operational and legal reasons, to identify which trade(s) represent the principal trade(s) related to a riskless transaction; therefore, introducing brokers and client firms would need to provide their clearing firm or service provider with the appropriate reference price or contemporaneous cost, which may require matching principal transaction(s) to the riskless trade. Leveraging a feed made available by MSRB and TRACE was described by one clearing firm as the optimal approach, as it would be seamless to the introducing brokers, with an implementation cost less than half of the \$500,000 estimated to capture contemporaneous cost or other reference price from the introducing broker. This estimate of \$500K does not include the cost that would be imposed on the many introducing brokers, which are primarily smaller regional firms, to identify the matching trades.

- Cons
 - FINRA or MSRB reference prices would not reflect the circumstances of that particular customer trade.
 - Retail customers will not understand the nuanced-differences between their trade and the time-weighted average price of others in the market. The onus would be on the investment advisor to explain the differences, with the facts and circumstances of the other trades unknown to him/her.
 - For those utilizing a real-time confirmation process, dealers do not want to hold up the confirmation to obtain the TRACE or MSRB end-of-day reference price. Similar to the issues with delaying the confirmation until end-of-day to capture potential principal trades, firms would want to expedite the process by capturing the most recent price or set of prices available in real-time from TRACE or MSRB. However, in this real-time scenario, a same day “look-back” may not produce any trades in that security, particularly if the transaction were to occur early in the day. In that case, some other methodology must be agreed upon.

Calculating Mark-Up/Mark-Down for Purposes of Disclosure

The MSRB proposal would require dealers to include the dealer’s mark-up or mark-down from the contemporaneous cost or the prevailing market price for the security on the customer confirmation. Dealers are required by MSRB G-30 fair pricing standards to perform diligence in determining the market value and reasonable compensation on any security at the time of proposing a bid or offer price. Following are the considerations regarding use of the “Prevailing Market Price” as the reference price from which the mark-up or mark-down would be calculated.

- Pro
 - A significant challenge is rooted in the fact that the large majority of municipal bonds trade infrequently. In most circumstances where there is no previous street-side trade execution or other transaction that may determine “contemporaneous cost” and no clearly identifiable “reference” trades, establishing a reasonable price and a fair mark-up is accomplished using many other inputs including: evaluated pricing, similar credits, market sector, transaction size, supply and demand considerations, and other relevant factors. However, because a reasonable method to determine the prevailing market price is required as part of the current business process, the prevailing market price and inputs to derive it should be readily available.
- Con
 - Despite the availability of a prevailing market price, FIF does not believe this price will be a clear metric for retail customers to understand. The inputs used to calculate the prevailing market price will not be disclosed on the confirmation, leading to a mark-up or mark-down based on a price with no context, which may confuse customers.

While the dealer’s contemporaneous cost is perhaps more relevant for establishing the mark-up/mark-down in a *riskless trade*, for reasons discussed previously, it is significantly more difficult and more costly to capture. However, for purposes of establishing the mark-up/mark-down in a *principal trade*, the issues are far more complex. The mark-up on a bond includes profit along with the cost of doing business. Dealers are hedging positions to reduce their amount of risk. Disclosing the mark-up to the customer will not factor in any potential loss incurred on the hedge. The costs of operating the business and maintaining an inventory should also factor into the mark-up. These factors will not be clearly identifiable to the customer on the confirmation which misleads the customer to believe that the mark-up is full profit for the dealer. Because a mark-up may include multiple components such as sales credit,

desk credit, and compensation for risk in the case of a principal trade, FIF members believe presenting a percentage of the price differential on the confirmation will confuse retail investors.⁷

As we've stated previously in this letter, we are not endorsing either a mark-up or reference price to be disclosed on customer confirmations. There appears to be no clear consensus amongst FIF members or the industry as to which proposal is preferred. Regardless of which methodology is ultimately selected by the regulators for the purposes of disclosure, FIF members believe that only the dollar amount differential should be displayed, and should only be applied in cases where the dealer firms themselves establish the "reference price" being used (e.g. contemporaneous cost). In cases where a third-party price (TRACE, MSRB or some other form of derived price that is not directly linked to the customer trade) is displayed, a difference expressed in terms of percentage and/or dollar amount is meaningless and misleading, as it does not accurately reflect the mark-up or how the bond was priced to the customer.

MSRB and FINRA should consider that customers do not currently receive a similar percentage of price differential on their confirmations, as no other asset class requires the percentage to be disclosed. Additionally, including the percentage spreads on the confirmation will require significant programming, as market data and other information not normally passed from front office systems to back office systems will need to be accommodated. This will lead to increased costs and time to implement.

Other Concerns

Impact on Liquidity

One potential "unintended consequence" of this initiative is firms may be driven away from carrying inventory and toward conducting agency-only business. While FIF comments are typically limited to implementation issues, FIF is mentioning this risk due to the anticipated difficulty and cost of implementing the mark-up or reference price disclosure requirements, which could contribute, in part, to a firm's decision to limit its principal trading and market making activities. Retail investors may be negatively impacted, as investment advisors look to external markets, rather than internally, to buy and sell bonds for their clients.

Inability to "Look Through"

In many firms there will not be an ability to "look through" to principal trades on the other trading desks that may supply offerings or bids for retail investors. With separate P&Ls, and most often conducting inter-dealer business on completely separate platforms, the opportunity to identify the principal leg of trade may not be obtainable until late in the transaction life-cycle after all trades have been processed.

Time of Execution

FIF members expressed concern in placing the Time of Execution on the confirmation for two primary reasons: 1) it will be an additional expense to parse that information from trading platforms, as this is not typically carried through to the back office systems that generate the confirmations; and, 2) it will not be possible to adjust the Time of Execution properly in conjunction with any trade modifications, cancellations or corrections. While we understand MSRB's intent in requesting the Time of Execution on

⁷ While FIF members fully understand the intent of this initiative is to disclose the full difference between the dealer's cost and the dealer's price to the customer, a simple and straightforward alternative would be to limit the disclosure on all retail customer confirmations to display only sales credit. This would provide increased transparency to retail customers in terms that are easily understood by the retail investor. The sales credit is known at time of the trade, it can be applied to any retail customer transaction regardless of a corresponding principal transaction, and is already passed on to the back office which would easily allow for the sales credit to be included on the customer confirmation with minor additional programming.

the trade confirmation is to support the investors' ability to look up the prices of similar trades on EMMA, the number of trades in each CUSIP listed on EMMA are so limited that investors will not have difficulty in ascertaining the prevailing market prices at or around the time of their trade. FIF members believe the Time of Execution is unnecessary information on a municipal bond confirmation, and it is not required on a confirmation for other security types.

Retail Confusion

In addition to the examples that have already been described, retail confusion may also be caused by the fact that these disclosures will only occasionally be provided; that is, they will apply to only certain "riskless" transactions. Furthermore, in response to the question regarding the form and format of the additional disclosure, FIF members believe that placing added information on a document separate from the confirmation will present additional challenges in bringing together documents that would be produced by separate systems. It would only add to customer confusion if the information was not delivered to the retail investor as one unit.

Summary

FIF believes this is a policy decision best left to the dealer firms to voice their opinions regarding trading and market making activities, and their positions and preferences with respect to additional disclosure on retail customer confirmations. Unfortunately, there appears to be no single solution that would accomplish the goals of full transparency, be easy for the retail investor to understand and straightforward to implement. Therefore, *FIF does not advocate or recommend the use of any particular method, but merely points out the implementation impacts of each approach.*

Again, we request that the implementation solutions for FINRA 15-36 and MSRB 2015-16 be consistent and realistic in terms of delivering information that is readily available, requiring limited or no manual intervention, and allowing the confirmation process to remain as automated as possible and processed in a timely fashion.

In conclusion, FIF would like to thank the MSRB and FINRA for providing the opportunity to comment on the proposed changes, and we support these efforts to establish a consistent, harmonized approach to transparency and disclosure.

Regards,



Darren Wasney
Program Manager
Financial Information Forum