Client Alert.

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FINRA Proposes Keeping the 5% Rule on Markups; Also Plans to Revise QIB Standards on Debt Securities

By Daniel A. Nathan

Habits can be tough to break. In 2011, FINRA attempted to break the broker-dealer industry's habit of relying upon a 5% ceiling for equity markups by proposing a new FINRA Rule 2121 that would eliminate the so-called "5% policy" currently embodied in NASD IM-2440-1. Last week, at the two-year anniversary of that proposal, and following its processing of comments on the proposal, FINRA chose to maintain the 5% policy, probably as much for its usefulness to FINRA in regulating fair pricing as for the member firms' reliance on a bright line standard to supervise their practices.

FINRA is seeking comments—by April 1—on that proposal and the other changes in the markup proposal, including the plan to eliminate FINRA's requirement proposed two years ago that firms establish and make available to retail customers schedule(s) of standard commission charges for transactions in equity securities with retail customers. This Alert will also discuss proposed changes to the criteria that firms must apply in qualifying for the exception from markup standards when selling distressed debt to QIBs.

THE 5% POLICY

FINRA proposes to transfer Rule 2440 into its new Rule 2121(a), including the longstanding rules that firms acting as principal must transact with their customers at prices that are fair and reasonable, and firms acting as agents must not charge customers more than a fair and reasonable commission or fee. The devil, of course, is in the details, and the most important detail for many years has been the 5% policy. According to its January 31, 2013 Regulatory Notice 13-07, proposing the new version of the markup rules, most commenters oppose FINRA's plan to eliminate that policy; they support the policy as effective in investor protection, and as helpful to firms in establishing effective supervisory and compliance procedures.

FINRA's bold attempt to break the 5% habit in 2011 might have failed because FINRA did not provide a substitute standard that might have provided the industry with a similar level of certainty. In its 2011 Regulatory Notice 11-08, FINRA explicitly stated that it was not

> propos[ing] a new policy based upon a lower percentage as this may encourage members to artificially peg (or cap) their markups, markdowns and commissions based upon the new percentage, instead of using the factors in the rule to rationalize their remuneration for the execution of transactions.

Apparently, the factors in the rule did not provide member firms with enough comfort in setting their own prices.

With the increases in competition and market efficiencies over the years, there is a fair argument that the 5% policy has become antiquated. In its Regulatory Notice, FINRA recites the history of the 5% policy. FINRA (then the NASD) originally based the policy on a 1943 industry survey in which 71% of respondents indicated that their transactions were executed with markups of 5% or less. Based on those findings, FINRA determined that in most transactions, markups of 5% or less would fall within the "fair and reasonable" standard and adopted the 5% policy as guidance. A recent study cited by FINRA found that average markups on equity transactions were closer to 2% than 5%. In its Regulatory Notice, FINRA recognizes that 5% is much higher than the average markup (or markdown) currently charged by most member firms, and attributes the change to reduced execution costs resulting from technological advances.

NASD IM-2440-1(a) also makes clear that the 5% policy is a guide and not a rule and that a markup pattern of 5% or even less may be considered unfair or unreasonable under the 5% policy. FINRA concludes its discussion of the 5% policy with this admonition:

> [A]lthough proposed FINRA Rule 2121 would retain the 5% policy, member firms should not view the provision as establishing a specific ceiling or cap below which most markups, markdowns or commissions will not be viewed as excessive (or will not be questioned).

FINRA's proposed Rule 2121 would adopt FINRA's current Rule 2440 and IM-2440, with certain minor changes to the current rule's considerations and factors. These are the most significant changes to the relevant factors:

- **The Availability of the Security in the Market.** FINRA expands on the provision that, in the case of an inactive security, the effort and cost of buying or selling the security may be a factor in determining the markup. FINRA explicitly recognizes that the effort and cost might be affected if the security is difficult to locate, is inactive or infrequently traded, and subject to market liquidity restraints, or if there are unusual circumstances connected with a security's acquisition or sale.
- **The Amount of Money Involved in a Transaction.** While the initial proposal provided that a transaction that involves a small amount of money might warrant a higher percentage markup, the revised proposal adds the corollary that, if a transaction involves a large amount of money, it could warrant a lower percentage markup.
- **Disclosure.** If a member is relying on disclosure of the commission or markup to a customer to support the conclusion that the member dealt fairly with the customer, such disclosure must provide the total dollar amount and percentage.

REQUIREMENT OF EQUITY MARKUP SCHEDULES IS ELIMINATED

Two years ago, FINRA recommended that, pursuant to proposed Rule 2121(e), firms would have to establish and make available to retail customers the schedules of standard commission charges for transactions in equity securities with retail customers. FINRA has now eliminated the requirement, responding to commenters who stated that the requirement would duplicate information already provided to customers, that posting the information would set a floor instead of fostering competition, and that providing a schedule would defeat the common practice of negotiating commissions. A member would be allowed to establish and publish multiple schedules of standard commission charges, as long as it discloses in or with the schedule(s) how the commissions are stratified among all retail customers.

CHANGES IN MARKUPS AND MARKDOWNS FOR DEBT SECURITIES

NASD IM-2440-2 sets the standards for markups charged on transactions in debt securities, but FINRA proposes tinkering with those standards as well. For the purposes of evaluating the fairness of markups on debt, the current markup rule does not apply to a qualified institutional buyer ("QIB") that is purchasing or selling a non-investment grade debt security, as long as the dealer has determined 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. Note that this exemption is only available for non-investment grade debt, which the rule defines based upon the security's rating. The rule defines QIBs by reference to Rule 144A under the Securities Act of 1933, which lists a number of types of financial institutions that satisfy the definition.

Two years ago, in Regulatory Notice 11-08, FINRA announced its plan to transfer those standards to proposed Rule 2122 without significant changes. However, FINRA now proposes to toughen the standard for determining whether a customer is a QIB. The revised proposal requires that a dealer *have a reasonable basis* to believe that a QIB is capable of evaluating investment risk independently, and the QIB must *affirmatively indicate* that it is exercising independent judgment in deciding to enter into the transaction.

Regulatory Notice 13-07 explains that one purpose for the rule change regarding debt is to align the criteria with the standards regarding institutional suitability in the revised FINRA suitability rule, Rule 2111, which took effect on July 9, 2012.   Similar to the new markup rule discussed above, Rule 2111 provides that a member or associated person has made a sufficient customer-specific suitability determination for an institutional account if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations.

To document the firm's determination of suitability, the proposed rule generally allows a firm to take a risk-based approach. Accordingly, Regulatory Notice 12-25 provides guidance on the new suitability rule, and states that a firm may consider obtaining a written affirmation from a customer that indicates the intention to exercise independent judgment, but it is not necessary. One additional benefit of obtaining such a certification would be the ability to take advantage of the QIB exemption in selling non-investment grade debt. We believe that a firm should consider whether the customer's independence speaks for itself and does not need to be documented, and also factor in the potential impact on the customer relationship of asking for such a certification.

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