Invested in America

March 15, 2013

BY ELECTRONIC MAIL

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: FINRA Regulatory Notice 13-07,
Markups, Commissions and Fees

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association[1] ("SIFMA") appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA's") Regulatory Notice 13-07 (the "Markup Proposal").

INTRODUCTION AND SUMMARY

SIFMA broadly supports FINRA's efforts to preserve the core components of existing NASD Rule 2440, IM-2440-1, and IM-2440-2 in the absence of consensus on appropriate alternatives to the "Five Percent Policy" and other modernization efforts. SIFMA also applauds the decision to avoid reliance on nonpublic studies or arbitrary benchmarks that risked undermining the facts-and-circumstances analyses called for by longstanding guidance and caselaw. Although SIFMA appreciates the decision to withdraw the proposed retail equity commission schedule requirement, it remains concerned that the proposed service fee schedule for retail investors presents unnecessary burdens and application difficulties while offering very little new information not already available to retail customers. SIFMA is also concerned that the introduction of certain new terms and requirements risks confusion and requests that FINRA either confirm SIFMA's understanding of their operation or amend them accordingly.

SIFMA regrets that the Markup Proposal does not include requested guidance across a variety of matters that have presented persistent difficulties for member firms in the daily application of IM-2440-1 and IM-2440-2. In the absence of such guidance, interstitial

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

interpretation will inevitably be set informally by examination and enforcement staff in the context of individual reviews, without ventilation of either the informal guidance or the views of member firms. SIFMA also continues to favor sensible modifications to the pricing hierarchy set forth in current IM-2440-2(b)(5) (proposed FINRA Rule 2122(b)(5)) (the "Pricing Hierarchy") to allow for greater flexibility in illiquid debt markets, such as the market for securitized products and distressed debt.

Finally, SIFMA is disappointed at the absence of any proposal to expand the so-called "QIB Exemption" given what appears to have been several years of successful administration by FINRA's Department of Market Regulation and member firms. In particular, FINRA should expand the QIB Exemption to apply to all transactions by Qualified Institutional Buyers ("QIBs") meeting the relevant standard in debt securities regardless of rating. SIFMA members with institutional bond trading desks believe that the QIB Exemption has been appropriately administered, and the absence of enforcement activity supports an expansion of this exemption.

DISCUSSION

I. SIFMA SUPPORTS RETENTION OF THE FIVE PERCENT POLICY IN THE ABSENCE OF CONSENSUS ON ALTERNATIVES.

SIFMA supports FINRA's decision to retain the Five Percent Policy, and the related concepts as described in the Markup Proposal and contained in proposed FINRA Rule 2121(b)(1). SIFMA previously supported FINRA's effort to retire the Five Percent Policy provided it was accompanied by the simultaneous provision of guidance and data relevant to the evaluation of markups and commissions by product and business model. In the apparent absence of consensus among commenters and FINRA as to appropriate alternative guidance, SIFMA agrees that the retention of the Five Percent Policy is the best available alternative. SIFMA continues to believe that the Five Percent Policy is a helpful warning track for compliance professionals, supervisors, traders, and regulatory staff – provided, of course, that all concerned acknowledge the importance of a facts-and-circumstances assessment. SIFMA also notes the absence of any other numerical benchmark proposed or adopted by FINRA and cautions against any effort to use nonpublic, numerical surveillance thresholds as substitute rules of thumb for evidentiary presumptions.

II. SIFMA OBJECTS TO THE INTRODUCTION OF NEW TERMS AND REQUIREMENTS IN PROPOSED RULE 2121.

A. The Term "Nearly Contemporaneous Trades" Is Novel and Risks Confusion by Member Firms and FINRA Staff.

SIFMA believes that the phrase "nearly contemporaneous trades" as used in proposed FINRA Rule 2121(b)(4) is confusing. Proposed FINRA Rule 2121(b)(4) states that generally when trading from inventory, a dealer's permitted markup or markdown is measured from current market prices, not from the dealer's actual cost. Proposed FINRA Rule 2121(b)(4) also states that riskless principal trades or "nearly contemporaneous trades" are excepted from this policy. This second term is nowhere defined in FINRA or SEC guidance and appears instead to have its origins in comments included in certain NASD settlements announced in 2004. Particularly when crafting standards for use in conduct rules, FINRA has a special obligation to use language with precision and uniformity. Member firms and their associated persons should not be placed in a position of deciding – on penalty of sanction – whether a particular trade was "nearly contemporaneous" (proposed FINRA Rule 2121(b)(4)) or "apparently simultaneous" or "virtually simultaneous" or "essentially riskless."[2]

In a "riskless principal" transaction, the dealer's cost to acquire a security is *always* the prevailing market price. That is because a riskless principal transaction is regarded as the functional equivalent of an agency trade – with the dealer transacting to fill orders in hand.[3] Riskless principal transactions should be treated differently than those that involve the incurrence of capital risk during which market conditions may change. Dealers often acquire securities in anticipation of potential customer interest on an at-risk basis. Customer transactions involving those securities may be executed shortly after a dealer acquires a position, in the same face amount, in a manner that may resemble a riskless principal transaction if evaluated solely by reference to close-in-time transaction reports. The term "nearly contemporaneous" – much like the term "essentially riskless" – appears to equate the successful discharge of risk with the absence of risk. A trade is either riskless (because a dealer had firm orders in hand), or it is not (in which case the dealer's capital is exposed).

The use of the phrase "nearly contemporaneous" is particularly confusing in this context for two reasons. First, FINRA continues to use the word "contemporaneous" in proposed FINRA Rule 2122(b) (current IM-2440-2, the "Debt Markup Rule"). The Debt Markup Rule states that a dealer's contemporaneous costs or proceeds is the best evidence of the prevailing market price. Despite repeated requests over the years, FINRA has yet to provide practical guidance on the meaning of "contemporaneous"[4] and this new variant threatens to make the term even less precise. Second, the term "nearly contemporaneous" is used to characterize both trades that are (1) "very briefly" in inventory and (2) same day transactions generally (by referring to

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2 *See* In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 3 (July 28, 2004); In re Goldman, Sachs & Co., NASD AWC No. 040106, at 4 (July 28, 2004); In re Miller Tabak Roberts Securities, LLC, NASD AWC No. CMS040112, at 3 (July 28, 2004).

3 In re Kevin B. Waide, Exchange Act Rel. No. 30561 (Apr. 7, 1992) ("Like an agent, a firm engaging in such a transaction has no market making function, *buys only to fill orders already in hand*, and immediately 'books' the shares it buys to its customers.") (emphasis added). Exchange Act Rule 10b-10(a)(2)(ii)(A) provides similarly.

4 SIFMA's comment letter in response to FINRA Regulatory Notice 11-08 specifically sought guidance on the meaning of "contemporaneous" for purposes of the Debt Markup Rule. *See* Letter from Sean Davy, SIFMA, to Marcia E. Asquith, FINRA (Mar. 28, 2011) ("SIFMA's Comments to Regulatory Notice 11-08") at 12.

profit or loss occurring "before, or after, the date of the transaction").[5] We believe that these multiple uses of the word "contemporaneous" are confusing.

Moreover, FINRA's use of the word "nearly" to modify "contemporaneous" suggests that the set of trades within the scope of proposed FINRA Rule 2121(b)(4) ("nearly contemporaneous") is different than the trades within the scope of proposed FINRA Rule 2122(b) ("contemporaneous"), yet both rules contemplate precisely the same type of trade. There is simply no reason why a trade would be sufficiently "contemporaneous" to be deemed the presumptive prevailing market price for proposed FINRA Rule 2121(b)(4) – and therefore making the exception from ignoring a member's profit and loss inapplicable – but not sufficiently "contemporaneous" to be the presumptive prevailing market price for calculating markups pursuant to proposed FINRA Rule 2122(b).

SIFMA believes that the phrase "nearly contemporaneous" should be deleted from proposed Rule 2121(b)(4), as market appreciation or depreciation is relevant to every trade done at risk given that market movements, including significant ones, may occur over quite short periods of time. SIFMA believes that the only class of trades for which market appreciation or depreciation would not be relevant would be riskless principal trades, where the dealer has in hand an open order and is buying or selling to fill that open order.

If FINRA won't delete the phrase "nearly contemporaneous" in its entirety, FINRA should at least omit the "nearly" qualifier as unnecessary or provide an assurance that the use of the phrase "nearly contemporaneous" in proposed FINRA Rule 2121(b)(4) is not intended to alter the requirements of the Debt Markup Rule related to the use of contemporaneous cost or proceeds to determine prevailing market price.

B. FINRA Should Not <u>Limit</u> the Consideration of Customer Disclosure In a Rule That Historically—and Sensibly – Called for the Opposite.

Since the initial adoption of IM-2440-1 (the "NASD Mark-Up Policy"), disclosure to customers of the amount of a markup or commission has been a relevant factor to be considered among the other attributes of a particular transaction. Never before has the form, substance, or manner of delivery of that disclosure been prescribed by a one-size-fits-all rule. FINRA should refrain from doing so now.

Proposed FINRA Rule 2121(c) provides a non-exclusive list of factors that members should take into account in determining whether a markup, markdown or commission is fair and reasonable. Proposed FINRA Rule 2121(c)(5) states that disclosure to the customer before the transaction is effected of both (1) the total dollar amount and (2) the dollar amount expressed as a percentage is a relevant factor in determining whether the charge is fair and reasonable. The proposed rule suggests that if the markup is not disclosed both as a percentage and as a dollar

[5] Regulatory Notice 13-07 (Jan. 2013), at 6 - 7.

figure, then the disclosure of one, but not the other, cannot be considered a factor in determining whether the charge is fair and reasonable. SIFMA does not believe that there is a sound policy basis for this limitation.

Because disclosure is just a factor and not a requirement, the *manner* in which firms choose to make disclosure should not determine *whether* that disclosure is to be considered. Requiring both methods of disclosure as a precondition to its consideration could lead to situations in which the amount of a given markup was objectively clear to the counterparty yet precluded from consideration. As proposed, FINRA Rule 2121(c)(5) would require FINRA to ignore disclosure entirely whenever a salesperson neglected to explain that a $300 markup on a $10,000 par bond was 3 percent. (Or, even more confounding, whenever a trader fails to explain to a hedge fund counterparty that a .125 point markup on a large block-sized transaction represented a particular percentage.) Such a requirement frustrates the regulatory purpose behind the rule – assessing all of the facts and circumstances of a particular transaction.

SIFMA requests that FINRA remove from the disclosure factor the requirement that both dollar and percentage must be disclosed in order for this factor to be considered. In its place, SIFMA suggests that FINRA could specify that the manner of disclosure would, under the circumstances, be taken into account in determining its relevance. FINRA should – and in our experience typically does – consider all pertinent disclosures made in connection with a particular transaction, whether that disclosure takes the form of a dollar amount and calculated percentage (proposed Rule 2121(c)(5)) or functionally equivalent disclosure such as the dollar amount, points, or incremental spread in the context of a known quantity (as permitted under current IM-2440-1). Indeed, for certain types of products and counterparty relationships in the fixed income markets, the existence of circulated bid lists and axe sheets ought to factor quite heavily in any assessment of the prevailing market conditions and, accordingly, the fairness of prices. For example, it is not uncommon for dealers transacting in securitized products such as non-agency mortgaged-backed securities ("MBS") to agree unambiguously to "work for x points" or for a counterparty to agree to "pay y points" – disclosure that plainly communicates the amount of remuneration that will be received by the firm without any need to spell out percentages or dollar sums to the institutional counterparty. Nor does SIFMA believe that *post*-transaction disclosures in compliance with the requirements of SEC Rule 10b-10 – a rule adopted by the SEC that specifically requires broker-dealers to disclose certain material information and under which undisclosed excessive markups have long been held to be violations - should be precluded from consideration solely because of the timing. The proposed change to IM-2440-1(b)(5) is overly prescriptive, at odds with the very purpose of the factor, and ought to be abandoned as unnecessary. The adequacy of retail disclosure is an issue that warrants consideration in a broader context.

III. FINRA SHOULD CLARIFY THE QIB EXEMPTION.

Proposed FINRA Rule 2121(d) states that the rule does not apply to a transaction in a non-investment grade debt security with a QIB that meets the condition set forth in paragraph (b)(9) of the Debt Markup Rule. Proposed FINRA Rule 2122(b)(9) excludes QIBs trading non-investment grade debt from the definition of "customer" for purposes of both proposed FINRA Rules 2121 and 2122. SIFMA has one clarifying comment on proposed FINRA Rule 2122(b)(9) related to its alignment with FINRA's recently adopted suitability rule.

Currently, the QIB Exemption in FINRA's Debt Markup Interpretation (NASD IM-2440-2) references the prior NASD institutional suitability interpretation, IM-2310-3, which FINRA repealed and replaced with FINRA Rule 2111 (the "Suitability Rule"), effective July 9, 2012. The Markup Proposal proposes to alter the language of the QIB Exemption in proposed FINRA Rule 2122(b)(9) to "align the criterion with the standards regarding institutional suitability in FINRA Rule 2111 (Suitability) . . . and expand the standards to apply to an authorized agent of a QIB."[6] SIFMA supports FINRA in updating the cross-references and applauds FINRA's explicit statement that the QIB Exemption, like the new Suitability Rule, applies to an authorized agent of the QIB.[7]

In one respect, however, the new QIB Exemption in proposed FINRA Rule 2122(b)(9) does not align textually with the Suitability Rule. In particular, FINRA Rule 2111(b)(2) states that "the institutional customer affirmatively indicates that it is exercising investment judgment *in evaluating the member's or associated person's recommendations*." Proposed FINRA Rule 2122(b)(9), by contrast, states that "the QIB affirmatively indicates that it is exercising independent judgment *in deciding whether to enter into the transaction*." In one respect, the different language makes sense. The Suitability Rule applies only to recommended transactions, whereas the Debt Markup Rule, including the QIB Exemption, applies to transactions whether or not recommended. SIFMA understands therefore why FINRA needed to avoid using the word "recommendations" in aligning the QIB Exemption in proposed FINRA Rule 2122(b)(9) to the new Suitability Rule. To the extent this is FINRA's intent, SIFMA supports the rule.

The proposed change to the QIB Exemption, however, introduces an ambiguity. In particular, the phrase "deciding whether to enter into the transaction," could be read to impose on dealers seeking to rely on the QIB Exemption a new requirement that is not contained in the Suitability Rule; namely, a requirement to obtain an affirmative indication on a trade-by-trade basis that the QIB is exercising independent judgment. SIFMA does not believe that FINRA was seeking to impose such a new requirement on members seeking to utilize the QIB Exemption, and requests that FINRA clarify that a member that obtains the affirmation required by FINRA Rule 2111(b) would be in compliance with the conditions of the QIB Exemption, and that the QIB Exemption does not require the QIB to make serial attestations on a trade-by-trade basis. SIFMA also suggests that FINRA clarify the rule on this point by deleting the definite article "the" from the phrase "the transaction" and replacing it with the plural "transactions."

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6 Regulatory Notice 13-07 (Jan. 2013), at 10.

7 For ease of reference and to avoid the need for serial conforming amendments in the future, SIFMA believes that the linkage to the Suitability Rule ought to take the form of an explicit cross reference in the text of Rule 2121(d) itself rather than an attempt to track or summarize its current requirements.

IV. SIFMA BELIEVES THE CATEGORY OF CUSTOMERS TO RECEIVE THE RETAIL FEE SCHEDULES AND SCOPE OF THE RULE SHOULD BE MODIFIED, AND THE ANNUAL DELIVERY REQUIREMENT ELIMINATED.

SIFMA is generally supportive of proposed FINRA Rule 2123(b) requiring members to make available to retail customers one or more schedules of charges and fees for services performed for retail customers. SIFMA is concerned, however, with the inclusion in the definition of "retail customer" in proposed FINRA Rule 2123(b)(3) of any natural person or any natural person advised by a registered investment adviser. In light of the proposed delivery requirement at account opening and coincident with proposed changes, SIFMA also believes that the annual delivery requirement should be eliminated as unnecessary. Finally, certain fees that are within the scope of the rule should be removed.

A. FINRA Should Use a Consistent Definition of "Retail Customer."

Proposed FINRA Rule 2123(b) requires members to make fee information available only to retail customers. The proposed Rule defines retail customer by reference to FINRA Rule 4512(c), which defines "institutional account." Proposed FINRA Rule 2123(b) then defines retail customer to mean any customer that is not an institutional account, as FINRA defines an institutional account in FINRA Rule 4512(c). SIFMA agrees with this basic approach. However, FINRA then goes on to include in the definition of retail customer for purposes of proposed FINRA Rule 2123(b) certain accounts that are actually defined as *institutional* accounts in FINRA Rule 4512(c). In particular, FINRA Rule 4512(c) includes within the definition of an institutional account: (1) a natural person with at least $50 million of assets; and (2) a SEC or state-registered investment adviser, regardless of the nature of the adviser's underlying client. FINRA does not provide any explanation for this approach in Regulatory Notice 13-07.[8]

SIFMA is concerned with FINRA's approach. First, at its most basic level it is confusing for FINRA to use different definitions of institutional customer in different rules. It creates confusion and opportunity for errors and traps, leading to "gotcha" moments during examinations. SIFMA strongly believes that FINRA should use defined terms uniformly in its rules, unless it can articulate a strong reason why it needs to implement a different definition for the purposes of a particular rule. Second, members may not have the data available easily to distinguish between investment advisers covering other institutional investors versus investment advisers covering natural persons and so this distinction between different types of institutional customers could impose a heavy burden on members. Third, in situations where natural person customers are covered by third party investment advisers, the member is performing essentially a clearing/carrying service for the investment adviser and may have limited direct contact with the underlying customer. In addition, the accounts may be wrap fee accounts, in which the retail customer pays a single fee to its investment adviser, and the investment adviser pays fees to the

8 Regulatory Notice 13-07 (Jan. 2013), at 11.

member. In these situations where the retail customer does not directly owe or pay fees to the member carrying its account, the provision of a fee schedule could be quite confusing to the customer. For these reasons, SIFMA strongly believes that FINRA should eliminate from proposed FINRA Rule 2123(b)(3) the exception for the definition of "institutional account" that would require members to provide fee schedules to categories of clients that are institutional accounts under FINRA Rule 4512(c).

B. FINRA Should Eliminate the Annual Delivery Requirement.

Proposed FINRA Rule 2123(b) would require member firms to provide a schedule of charges and fees for services performed for retail customers (1) "at the opening of an account"; (2) upon any change or addition of a new "form of charge or fee"; and (3) at least annually. In light of the first two categories of disclosure, the annual delivery requirement seems an unnecessary redundancy. There is no explanation in the Markup Proposal as to the reason why delivery of these schedules at the time of account opening and upon any changes to it would be inadequate, nor does it refer to any study that suggests that the value of redundant disclosure would outweigh the costs of its provision. SIFMA continues to believe that disclosures to retail customers ought to be considered comprehensively, in the context of efforts pursuant to Regulatory Notice 10-54 or similar such initiatives, and not in a manner that risks unintentionally elevating certain disclosures above others.

C. The Scope of Services Subject to the Rule Should be Modified.

Proposed Rule 2123(a) would apply to certain fees that are not traditional broker-dealer related processing fees and that are instead typically the subject of separate agreements and regulation. These fees include those for "customer portfolio analysis" and "tax advice"; both of which are subject to different regulatory schemes with specialized rules. FINRA should not, in the context of a conduct rule addressing mark-ups and fees, risk creating disparate requirements for the provision of services that are both separately regulated and the subject of bilateral negotiations.

V. SIFMA CONTINUES TO BE CONCERNED THAT THE DEBT MARKUP RULE IS UNWORKABLE IN ILLIQUID MARKETS, SUCH AS THE MARKET FOR SECURITIZED PRODUCTS.

Since the SEC approved IM-2440-2 in 2007, dealers in debt securities have operated under the Pricing Hierarchy where the dealer's cost is not "contemporaneous." In letters submitted throughout the course of prior rulemakings, SIFMA and a variety of other commenters warned about the workability of the Pricing Hierarchy in highly illiquid markets, and especially in the market for securitized products.[9] Six years of activity have not lessened those concerns.

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[9] *See e.g.*, Letter from Robbin Conner, Vice President and Assistant General Counsel, SIFMA, to Nancy M. Morris, Secretary, SEC (Jan. 4, 2007).

SIFMA continues to believe that a strict application of the Pricing Hierarchy may lead to inaccurate determinations of prevailing market price because it does not fully reflect the way that dealers and institutional counterparties make pricing determinations in illiquid markets, especially those typified by securitized products.

For example, a dealer contemplating transacting in a distressed (but still investment-grade-rated) non-agency MBS must first inquire as to the existence of any "contemporaneous inter-dealer transactions" in a given security.[10] But, unlike the market for certain types of corporate bonds, there would be little if any available information about dealer-to-dealer transactions because of the heterogeneous nature of securitized products. Similarly, the next few factors in the hierarchy typically would provide no useful information: Dealers would not likely be aware of institutional transactions in the same security occurring away from them (IM-2440-2(b)(5)(B)), the security would not be "actively traded" such that resort to quotations will be permitted (IM-2440-2(b)(5)(C)), and there doubtfully would be any securities "similar" to the bespoke non-agency MBS (IM-2440-2(b)(6)), leaving the modeling proviso in IM-2440-2(b)(7) as the dealer's only resort – which carries with it requirements that are overly prescriptive and call for the inclusion of metrics that may not be relevant for certain types of products.[11]

For these and other types of illiquid debt products, FINRA should allow for much greater reliance on pricing models and the host of informal data points that are in fact used by dealers, their trading personnel, and their institutional counterparties to analyze, price, and transact on a daily basis. These pricing decisions would, of course, remain fully subject to the very sort of facts-and-circumstances analysis that FINRA is quite capable of undertaking.

VI. ADDITIONAL ISSUES.

In SIFMA's Comments to Regulatory Notice 11-08, we raised additional issues that FINRA has not addressed in the current rulemaking. SIFMA continues to believe that the issues listed below are important, and accordingly we incorporate those discussions herein by reference, and ask FINRA to keep these issues in mind in connection with the continued evolution of its rules.

A. Expansion of the QIB Exemption.

SIFMA continues to believe that FINRA should expand the QIB Exemption to apply to all transactions by QIBs meeting the relevant standard in debt securities regardless of rating, consideration of which was explicitly postponed in 2007 pending greater regulatory experience

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[10] IM-2440-2 (b)(5)(A).

[11] For example, "time to maturity," "call provisions," and movements in benchmark interest rates have less relevance for securitized products in light of their structure than for investment grade corporate bonds and agency securities.

with its administration.[12] Congress, the SEC, and FINRA have each endorsed the need for regulation tailored to meet the different needs of retail consumers and sophisticated institutions in the financial services context and that distinction continues to makes sense. Moreover, since 2007 Congress and the SEC have endeavored to reduce or eliminate reliance on rating agency designations in rules.[13]

FINRA has now had several years of experience with the QIB Exemption and has undertaken numerous transaction-specific inquiries implicating its provisions. SIFMA members with institutional bond trading desks believe that the FINRA Market Regulation staff surveillance and investigation activities have appropriately administered this exemption by conducting appropriately tailored reviews of these trades. There has been a complete absence of any enforcement activity that would suggest that abuses have occurred or were hidden because of the QIB Exemption.

Accordingly, SIFMA recommends that FINRA expand the QIB Exemption to cover all debt securities, not merely securities that have a particular rating. If FINRA is not willing to expand the QIB Exemption to cover all debt securities, at the very least, FINRA should consider a more modest expansion of the QIB Exemption that would take into account that certain investment grade-rated debt trading at levels more typically associated with junk ratings are regularly evaluated by dealers and customers alike as below investment grade securities. Trading in these types of "fallen angels"[14] is typified by counterparties with the same level of market sophistication as those that trade "non-investment grade debt securities" meeting the current definition. By expanding the scope of the QIB Exemption to apply to debt securities that, regardless of rating, have experienced a deterioration in credit quality – as evidenced by a marked increase in credit spreads that demonstrate an investment grade rating is no longer reliable – the class of debt securities covered would remain as intended and within a familiar, workable framework.

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[12] *See* Letter from Sharon K. Zackula, Associate General Counsel, NASD, to Katherine England, Assistant Director, Division of Market Regulation, SEC (Jan. 12, 2007) at 5. *See also* SIFMA's Comments to Regulatory Notice 11-08 at 10-12.

[13] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, § 939A (111th Cong. 2d Sess. 2010) ("Review of Reliance on Ratings").

[14] Fallen angels are bonds that are issued at investment grade status but later descend into below investment grade status. Their pricing and trading behavior often exhibit distressed characteristics before downgrades occur. Floyd Norris, *Junk Bonds May Yet Earn Their Title*, N.Y. Times, Nov. 16, 2006, at C1. Bundled securities, including MBS, are especially sensitive to changes in ratings because of their concentrated risk. Even a slight change in the market's perception of the risk of a product can have a disproportionate effect on the product's market price, such that a triple-A security that is reduced to a double-A or single-A can collapse in price even without there being any default. *See* Blair A. Nicholas and Ian D. Berg, *Credit Rating Agencies: Out of Control and In Need of Reform*, Andrews Delaware Corporate Litigation Reporter, 23 No. 26 Andrews Del. Corp. Litig. Rep. 3 (Jul. 13, 2009).

B. Meaning of "Contemporaneous."

SIFMA reiterates its request that FINRA provide additional guidance on the meaning of "contemporaneous" in the Debt Markup Rule, given the asymmetrical risks firms face in taking on inventory positions, even for what a FINRA examiner may later deem to be a short period of time.[15]

C. Dealers Need To Be Compensated for the Provision of Liquidity.

SIFMA reiterates its position – fully consistent with current NASD Rule 2440, IM-2440-1, and Exchange Act Section 3(a)(38) – that dealers are entitled to be compensated for placing their capital at risk to provide liquidity to facilitate customers out of substantial positions.[16] SIFMA believes that a dealer that is willing to commit substantial capital to take down a position from a customer of a particular size at a level that prices in the risk of holding the position should not be challenged based on the pricing of a transaction that is not similar in size or associated risk. FINRA should acknowledge the market reality that dealer risk does and should bear on the pricing of any given transaction.

D. Certain Trades Reasonably Carry Comparatively Higher Markups.

SIFMA reiterates its request that FINRA issue commentary acknowledging that certain transactions, such as retail trades, odd lot trades, and trades in low dollar priced securities reasonably carry comparatively higher markups[17]—a point recognized in decisional authority and informally by surveillance and examination staff.[18] Proposed Rule 2121(b)(4)'s confirmation that certain transactions, such as those involving comparatively small amounts may warrant a higher percentage markup (and vice versa) is helpful in this respect. SIFMA notes, however, that the reference to handling costs should not be treated as the sole criterion by which a markup may be justified and, to the extent that this language suggests a percentage or dollar cap on permissible dealer compensation it would be inconsistent with decisional authority and the Exchange Act.[19]

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15 *See* SIFMA's Comments to Regulatory Notice 11-08 at 12 – 13. *See also* Part II.A, above, discussing the proposal's use of the undefined term "nearly contemporaneous."

16 *See* SIFMA's Comments to Regulatory Notice 11-08 at 20 – 23.

17 *See* SIFMA's Comments to Regulatory Notice 11-08 at 13 – 14.

18 *See e.g.*, NASD Rule 2440 (which permits the "the expense involved, and the fact that the [dealer] is entitled to a profit" to be taken into account when assessing whether a price or commission is fair).

19 In re Wheeler Municipals Corp., Exchange Act Rel. No. 28510 (Oct. 3, 1990); Exchange Act § 15A(b)(6).

E. Debt Securities that Trade at a Spread to a Benchmark Interest Rate.

SIFMA reiterates its request that FINRA acknowledge that where debt securities trade on a spread to a benchmark, changes in the benchmark may be better evidence of prevailing market price than the member's costs or proceeds.[20]

F. Assumptions as to Securitized Products.

SIFMA reiterates its request that FINRA expressly acknowledge that minor differences in assumptions about underlying assets can lead to significant differences in pricing views for securitized debt.[21]

G. Pricing Flexibility.

SIFMA reiterates its request that FINRA allow members more pricing flexibility with QIBs rather than requiring rigid adherence to a particular hierarchy of factors.[22]

H. Trades in Advisory Accounts.

SIFMA reiterates its request that FINRA address the fact that TRACE reports of bond fees in advisory accounts do not include customer charges, whereas TRACE reports of bond fees in brokerage accounts include markups, markdowns or commissions, obscuring pricing information and complicating use of TRACE data for surveillance purposes.[23]

I. The Outdated Maxim About Debt Markups Should Be Retired.

SIFMA reiterates its request that FINRA remove the observation in proposed FINRA Rule 2121(c)(1) (current IM-2440-1(b)(1)) that "a higher percentage markup customarily applies to a common stock transaction than to a bond transaction of the same size."[24] This observation has very little currency in markets, such as the markets for high yield and distressed debt or the market for securitized debt products. This observation also fails entirely to recognize that certain types of debt securities often trade with higher markups for reasons having to do with greater risk, the need for a "finding" function, the need to develop specialized knowledge, the need to educate potential sellers and buyers about the credit instrument, and other features special to modern debt markets.

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20 *See* SIFMA's Comments to Regulatory Notice 11-08 at 14.

21 *See* SIFMA's Comments to Regulatory Notice 11-08 at 14 – 15. *See also* Letter from Mary Kuan, Vice President and Assistant General Counsel, SIFMA, to Nancy M. Morris, Secretary, SEC (Jan. 3, 2007) at 8.

22 *See* SIFMA's Comments to Regulatory Notice 11-08 at 15 - 16.

23 *See* SIFMA's Comments to Regulatory Notice 11-08 at 16.

24 *See* SIFMA's Comments to Regulatory Notice 11-08 at 10.

CONCLUSION

SIFMA thanks FINRA for the opportunity to comment on the Markup Proposal. If you have any questions, please do not hesitate to call me at 212-313-1118 or Paul Eckert, SIFMA's outside counsel at Wilmer Cutler Pickering Hale and Dorr LLP, at 202-663-6537.

Respectfully submitted,

Sean Davy
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Corporate Credit Markets Division
SIFMA