BDA Bond Dealers of America

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VIA ELECTRONIC MAIL

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

Re: Comments Regarding Regulatory Notice 11-08: Proposed Consolidated FINRA Rules Governing Markups, Commissions and Fees

Dear Ms. Asquith:

The Bond Dealers of America (the "BDA") is pleased to offer comments to the Financial Industry Regulatory Authority, Inc. ("FINRA") in response to Regulatory Notice 11-08: Proposed Consolidated FINRA Rules Governing Markups, Commissions and Fees (the "Regulatory Notice"). The BDA is the Washington, DC based trade association representing securities dealers and banks focused primarily on the U.S. fixed income markets.

FINRA is requesting comment on proposed consolidated FINRA rules governing markups, markdowns, commissions and fees as well as requirements for member firms to provide retail customers with schedule(s) of charges and fees for services provided. The proposed transfer of National Association of Securities Dealers, Inc. ("NASD") Rule 2440 and NASD Interpretive Material-2440-1 to the Consolidated FINRA Rulebook ("Rulebook") as FINRA Rule 2121 with significant changes to reflect current practices in the equity markets after a study of 161,000 equity transactions presents a sharp contrast to the proposed transfer of NASD IM-2440-2, which provide the standards for markups and markdowns for transactions in debt securities. In general, the BDA believes that this Regulatory Notice does not adequately address the realities of the debt securities market. The BDA believes that the proposal exacerbates the current uncertainty, does not reflect the market realities when firms trade on a principal basis, especially when they are market-makers, and as a result favors and encourages agency trading as a business model, to the detriment of investors.

1. *Lack of Clear Guidance for Market Makers in Debt Securities.* The Regulatory Notice fails to provide guidance regarding market maker status for purposes of determining fair and reasonable mark-ups in debt securities which has resulted in dealers being treated differently based on whether they operate with capital at risk or not. In addition, much of the interpretation of the statutory definition of market maker has developed in the context of equity securities. Both the Securities and Exchange Commission ("SEC") and the NASD have acknowledged that a dealer meeting the standards of the three-prong test of Section 3(a)(38) of the Securities

Exchange Act of 1934, as amended (the "Act"), would qualify as a market maker[1] but current guidance does not clearly address what steps a fixed-income dealer might take to satisfy the "holding out" standard of Section 3(a)(38). In 1998, the NASD issued a proposed interpretation of the definition of market maker that fit the debt markets and was responsive to two of the three prongs of the Act's definition:

> "In the debt securities markets, a market maker is a dealer who, with respect to a particular security, furnishes bona fide competitive bid and offer quotations on request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers."[2]

This proposed interpretation clarified how, with respect to debt securities, a dealer may qualify as a market maker by holding itself out as willing to commit capital or act as a block positioner to execute transactions. A return to the NASD's proposed 1998 interpretation of the definition of market maker would provide welcome certainty for dealers striving to comply with the mark-up policy. BDA urges FINRA to address the uncertainty that currently plagues the debt markets on this point.

The BDA has requested that a definition of market maker for debt instruments be established.[3] We reiterate that request with FINRA. The Financial Stability Oversight Council has noted the lack of definition of market maker for debt securities and suggested principles for identifying market makers in debt securities.[4] This is an issue that FINRA and other regulatory bodies will have to confront sooner rather than later, because being a market maker is an exception to the prohibitions under the "Volker Rule" and regulations implementing that rule are to be in place by September 2011.

2. *Lack of Definitive Enforcement Standards for Determining if Markups and Markdowns are Fair and Reasonable.* Proposed FINRA Rule 2122 would transfer IM-2440-2 without any

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[1] Securities Exchange Act Rel. No. 34-55638, (Apr. 16, 2007) (Approving Release). at 16, n. 56 and 18, n 60. In SEC Release No. 34-55638 (April 16, 2007) (the "Release"), the SEC stated specifically that to be a market maker, "a dealer must meet the legal requirements set forth in the Act, which provides, in relevant part, that a dealer must hold itself out as being willing to buy and sell a security for its own account on a regular or continuous basis." The SEC did not explain in the Release its focus on only the third prong of the Section 3(a)(38) definition.

[2] *See* Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government and Other Debt Securities, Exchange Act. Rel. No. 40,511 (Sept. 30, 1998), 63 Fed. Reg. 54,169 (Oct. 8, 1998).

[3] Letter from Michael Nicholas, CEO of the Bond Dealers of America, to James Eastman, Chief Counsel and Associate Director, Division of Trading and Markets, Securities and Exchange Commission, September 15, 2010.

[4] Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds at 29 (January 2011).

significant changes. Rule IM-2440-2, which will become FINRA Rule 2122, provides that while that each markup should be judged on its own merit, consideration will be given to a firm's pattern of excessive commissions. In lieu of stating simply that a markup, markdown or commission of less than a specified percentage is not excessive, FINRA expects to provide future guidance that markups, markdowns and commissions above certain specified ranges will be subject to additional regulatory scrutiny and will require dealers to provide additional justification to establish that such markups, markdowns and commissions are not excessive. FINRA currently conducts its quarterly markup reviews by pursuing an Acceptance, Waiver and Consent ("AWC") for any dealer that has five or more alleged violations during a quarter. This approach unfairly punishes dealers that execute a large number of transactions during a typical quarter. For example, a dealer could execute and report 50,000 trades in a quarter and have five alleged violations, a 99.99% compliance rate, and yet FINRA would still pursue an AWC. While the BDA does not suggest that FINRA ignore the five trades identified in the example given, if FINRA is to move forward with a revised markup rule or provide additional guidance, then the BDA respectfully requests that a pattern and practice standard be established for enforcement of Proposed FINRA Rule 2122 similar to the one in place for trading, where both an absolute number and a percentage have to be exceeded.

3. *Failure to Recognize that Spreads for Distressed Bonds Are Higher than for Non-Distressed Bonds*. FINRA has repeatedly asserted, and the Regulatory Notice continues to assert, that price volatility in and of itself is not a justifiable reason for a higher markup. However, while interdealer brokers may be willing to buy and sell a bond at a narrow difference if a bond has a stable price, the spread between the bid and offer prices for distressed securities may be significant – as much as four or five points during times of market volatility. Fixed income securities include significantly complex and volatile securities and derivatives that are no less sensitive, and therefore risky, in their response to interest rate changes than most equity securities are to projected and actual earnings. FINRA's unwillingness to recognize the increased spreads for distressed securities has already caused some dealers to decide not to trade distressed debt securities on a principal basis and only trade such distressed debt securities as agent. Such decisions ultimately reduce the number of firms providing bids and offers in such securities with the unfortunate result that retail customers will bear the burden of increased fees and charges and market illiquidity. This distinction needs to be addressed in the evaluation of whether a markup is fair and reasonable.

4. *Contemporaneous Cost Approach Needs to be Revised.* Proposed Rule 2122 continues to presume that a dealer's contemporaneous cost or proceeds is the prevailing market price of a debt security. Prevailing market price is the price from which a dealer must calculate any markup or markdown and is a critical part of the analysis of the reasonableness of any mark-up and yet whether or not a prior trade is considered contemporaneous depends on whether the transactions occur close enough in time that they would reasonably be expected to reflect the current market price for the security. In addition to being a standard that is difficult for dealers to apply, FINRA's contemporaneous cost approach goes beyond simply ensuring that retail clients receive a fair markup. It requires dealers to take a loss when the price of a bond declines, but prohibits them from recognizing a gain when it increases. This ignores a dealer's

significant capital risk in taking down inventory and removes any incentive for them to do so and rewards those trades made by dealers who are trading in a riskless capacity. Dealers are less willing to engage in trades or buy debt securities for their own inventory on a principal basis – especially very illiquid securities – because of the regulatory risks and the risk of economic loss. For example, if a firm buys into inventory a block of a particular bond at a particular price then the dealer must use that price as the basis for offering those bonds to their customers regardless of whether the bonds begin to trade at a higher price. Such price movements may be caused by imbalances of supply and demand and may not be the result of the three exceptions to the contemporaneous cost presumption (interest rates changes, credit quality changes, and news or recent developments known to the marketplace) that are acceptable to FINRA. As such, FINRA expects firms to lose money when holding a bond that decreases in price, but not to profit if holding a bond that increases in price.

5. *Fixed Income Securities are Different from Equity Securities.* Rule 2121 would eliminate the existing 5% policy set forth in IM-2440-1 because FINRA believes that the policy is "outdated" and does not reflect current industry practices based on a study of equity securities and FINRA's understanding that 5% is higher than the average markup or markdown currently charged for debt securities.[5] FINRA also cites to an uncompleted review of TRACE data for the first two quarters of 2008 and the SEC's staff position that debt markups and markdowns are generally lower than the equivalent remuneration in equity transactions. The BDA believes that FINRA should not rely on an uncompleted, unpublished and unreviewed study to make policy. We are especially concerned that the time period covered by the study is one of the more atypical periods in recent market history. Further, especially without a factual basis, we do not believe that FINRA should rely on SEC staff beliefs that markups and markdowns are generally lower in debt markets. There are significant differences between the markets, not the least is that equities are traded on exchanges and one share of stock is the same as another. Fixed income securities have much more variety. Further, the business model for much equity trading has shifted in recent years to discount, on-line brokers, in a way that does not lend itself to the fixed income markets, so that markups and markdowns are not as significant in the equity markets. In essence, simply comparing markups and markdowns in the equity and fixed income markets is like comparing apples and oranges.

6. *Reasonableness of Markups Need to Reflect Practices in Fixed Income Market.* Further, fixed income securities have a maximum markup for the long end of the yield curve (more than 10 years to maturity) and then the markup decreases as the years to maturity decrease. The markups that would be deemed to be fair and reasonable for a security with a long maturity may not be so for the same security with a shorter maturity. In lieu of stating simply that a markup, markdown or commission of less than a specified percentage is not excessive, the Regulatory Notice states that FINRA expects to provide future guidance that markups, markdowns and commissions above certain specified ranges will be subject to additional regulatory scrutiny and will require dealers to provide additional justification to establish that such markups, markdowns

[5] Regulatory Notice 11-08, p. 5, http://www.finra.org/Industry/Regulation/Notices/2011/P122919 ("Regulatory Notice 11-08").

and commissions are not excessive. FINRA should revise the proposed rules to provide guidance to the dealers as to what the maximum allowable mark up would be for debt securities generally and specifically for debt securities with shorter maturities.

In addition to requesting comments on proposed consolidated FINRA rules governing markups, markdowns, commissions and fees, the proposed rules include a new requirement for member firms to provide retail customers with schedule(s) of charges and fees for services provided. BDA believes retail customers should have advance notice of increases in the fees and charges that a dealer may be charging for its services or new fees so that such customers may review the increased charges, compare them with those of other dealers and decide if they wish to continue doing business with the firm. However, if a dealer is reducing its charges and fees across all classes or types of customers, what is the harm if a dealer implements those reductions in less than 30 days? While the BDA generally agrees with Proposed FINRA Rule 2123 and the protections it affords retail customers, it should be amended to allow dealers to implement reductions in the charges and fees imposed on retail customers immediately without the thirty days advance notice proposed.

This Regulatory Notice does not provide clear guidance to dealers of debt securities and it would, in fact, be premature to provide such guidance based on an incomplete study of TRACE-eligible debt securities from 2008. Basing conclusions on a not-yet completed study of debt securities transactions from the first two quarters of 2008 – a time of unprecedented volatility in the debt markets – is unfair to industry participants who are unable to review the details of the study and provide informed feedback and analysis regarding FINRA's conclusions drawn from the study. While average markups, markdowns and commissions may have declined over time, there is still a great deal of uncertainty as to what is required of firms in order to avoid regulatory scrutiny and to achieve fair and reasonable standards for transactions in debt securities. Guidance regarding the definition of market maker for fixed income securities and definitive enforcement standards would provide welcome certainty for dealers striving to comply with the mark-up policy and would encourage more dealers to take the risks associated with making a market, thus providing investors with greater liquidity. That greater liquidity will, in turn, foster a more efficient market and better pricing for investors.

Thank you for this opportunity to present our views. Please do not hesitate to call if you have any questions.

Sincerely,

Mike Nicholas
Chief Executive Officer