Consumer Federation of America

December 11, 2015

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

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

Re: FINRA Regulatory Notice 15-36; MSRB Regulatory Notice 2015-16
Pricing Disclosure in the Fixed Income Markets

Dear Ms. Asquith and Mr. Smith:

I am writing on behalf of the Consumer Federation of America (CFA)[1] regarding FINRA's and MSRB's revised proposals to require confirmation disclosures for retail fixed income transactions. In January 2015, CFA expressed its strong support for FINRA's and MSRB's initial proposals to require heightened confirmation disclosures, which we thought provided critical cost information that would benefit retail investors significantly.[2] After receiving feedback, FINRA has proposed certain technical adjustments to its proposal that would improve the rule's workability without undermining the regulatory goals of allowing retail investors to make more informed investment decisions and fostering increased price competition in fixed income markets. However, the same cannot be said for MSRB's revised proposal, which would allow firms to easily evade their confirmation disclosure requirements, thus undermining the goals the disclosures are seeking to promote.

While regulatory coordination and consistency are desirable goals, they must not be used as justifications for weakening crucial investor protections. Toward this end, if both SROs favor a coordinated approach, they should finalize a rule that closely tracks FINRA's revised proposal, not the MSRB's.

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[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

[2] FINRA Regulatory Notice 14-52; MSRB Regulatory Notice 2014-20, http://consumerfed.org/pdfs/FINRA-MSRB-proposed-rules-01-20-2015.pdf

I. FINRA's revised approach requiring disclosures for same-day transactions still achieves the goals that these disclosure are intended to promote, while MSRB's revised approach requiring markup disclosures based on a narrow two hour timeframe undermines the goals these disclosures are intended to promote. MSRB must return to a same-day transaction approach if it hopes to provide retail investors with critical cost information.

FINRA's revised proposal refines without undermining its initial proposal to require firms to disclose additional pricing information for retail customer trades in corporate and agency debt securities. As in the initial proposal, firms that buy (sell) as principal with their customers in corporate and agency debt security transactions and on the same day sell (buy) the same securities must disclose on their customer confirmations the price to the customer, the price to the firm of the transaction in the same security, and the differential between those two prices.

Reiterating our previous comments, we strongly support requiring disclosure of pricing information for all trades in the same security on the same day of trading rather than limiting disclosure to riskless principal markups. Requiring disclosure for all same-day trades would allow for a more mechanical analysis by firms which, in turn, would make it easier for investors to compare transaction costs across firms. Disclosing riskless principal markups, on the other hand, would reduce the comparability of transaction cost information across firms. Because what is considered a riskless principal markup is susceptible to varying and often arbitrary interpretations, using a riskless principal markup standard could result in inconsistent markup calculations.

Requiring disclosure for all same-day trades would also decrease the possibility of evasion, as this time-frame is broad enough to capture the vast majority of trades that are currently made on a matched basis or can reasonably be expected to be made under the rule. Requiring disclosure for a narrower window, however, would create incentives for firms to hold positions long enough to avoid their disclosure obligations and, perversely, encourage firms to remain exposed for longer periods throughout the day. As a policy matter, a rule that requires enhanced disclosure should neither be gameable nor encourage risky behavior. FINRA's same-day trading approach achieves those goals, though we encourage FINRA to continue to monitor trading practices after the rule is adopted to ensure that the rule is not being gamed.

In contrast, it is difficult to see how MSRB's revised approach requiring disclosure of markups only for dealer trades that occur within two hours of a customer's transaction achieves any sensible or meaningful policy goals. If, in order to evade the rule's requirements, a significant number of firms hold onto positions beyond the 2 hour window, retail customers would not receive pricing disclosure and would be no better off than they are today. That is a predictable outcome of the rule. While saying that it is not proposing to use a two-hour timeframe to define what a "riskless principal" transaction is, that is effectively what MSRB is doing for purposes of this proposal. And, by saying that two hours is "sufficient to cover transactions that could be considered 'riskless principal' transactions under any current market understanding of the term," it is implying that anything longer might not be considered "riskless." As with other approaches to considering what a riskless principal transaction is, this two-hour approach is arbitrary, as it is based neither on function nor on known or expected market dynamics.

The two-hour timeframe also would create incentives for firms to hold positions long enough to evade the rule's disclosure requirements. Firms that currently match trades in under 30 minutes would have an incentive under the rule to delay their trading for 2 hours and 1 minute to avoid their

disclosure obligations. So, while *current* TRACE and EMMA data indicate that the vast majority of same day retail-size match trades occur within 30 minutes of each other, regulators should not infer that those trading behaviors would remain under the rule. And, while FINRA's proposal states that the revised FINRA approach and the MSRB's approach would produce similar outcomes "in many circumstances," that statement is reflective of what the outcomes would be under current market conditions, not under different incentives that would likely alter trading behavior. Further, as FINRA's proposal makes clear in footnote 31, MSRB's approach is likely to be much narrower in practice than FINRA's approach and result in less disclosure to retail investors. According to TRACE data from the first quarter of 2015, for example, 38 percent more retail-size trades would have received FINRA's proposed reference price information than had those trades been limited to riskless principal trades. Thus, even under current market dynamics, a riskless principal markup approach would result in retail investors' receiving less price disclosure than they would under a same-day approach. Instituting a riskless principal markup approach that changes firms' incentives to hold past the point they are required to disclose would result in even less disclosure than that.

The two-hour timeframe would also encourage firms to remain exposed for longer periods throughout the day than they might otherwise be. Under firms' current regulatory incentives, the threat of firms' being exposed to disadvantageous market movements mitigates firms' incentives to remain exposed longer than necessary. However, this rule introduces a new incentive, avoiding disclosure, which counteracts that threat. In most circumstances, holding onto positions for a few extra hours will not materially increase firms' risk profiles, which may push them to holding positions longer. However, should there be material changes to the prices of securities during an unexpected period of high volatility, which will inevitably happen from time to time, a firm's exposure could result in serious losses to the firm. It is inappropriate for regulators to introduce incentives that encourage such risky behavior, even if the circumstances that can lead to serious losses occur rarely.

It appears from footnote 19 in MSRB's reproposal that the MSRB has revised its approach in response to substantial broker-dealer industry opposition to MSRB's and FINRA's initial proposals. Specifically, MSRB cites to comments by the Securities Industry and Financial Market Association (SIFMA), Morgan Stanley Smith Barney, LLC and Wells Fargo Advisors, LLC claiming that markup disclosure on riskless principal transactions "could achieve similar or greater benefits than the pricing reference proposal but at significantly lower cost" and comments by Bernardi Securities, Financial Services Roundtable (FSR) and Hilliard Lyons, favoring limiting any disclosure to riskless principal transactions. But the role of regulators is not simply to take their cues from members of industry, who have obvious incentives to curtail the information they provide to investors. The role of the MSRB, as it notes in its mission statement, is to "protect investors, municipal entities and the public interest by promoting a fair and efficient municipal market, regulating firms that engage in municipal securities and advisory activities, and promoting market transparency."

Despite this investor-focused mission, nowhere in its comments does MSRB even acknowledge CFA's initial comment expressing strong support for the same-day pricing reference approach, much less respond to our comments expressing support for that approach. Instead, MSRB merely adopts the same view as the industry "based on careful consideration of all of the comments received on the pricing reference proposal…" The inherent lack of balance in the regulatory process, which results from the fact that industry comments will *always* outnumber comments from investors and investor advocates, is made worse when regulators choose simply to ignore the investor comments they do receive. By focusing exclusively on industry objections and ignoring investor benefits of its original approach, MSRB has proposed an approach that would allow firms to disclose

pricing information to the extent it is most conducive to those firms, rather than what is most conducive to market integrity and retail investor protection.

For the above reasons, we urge MSRB to return to its original approach, which better protects investors, does more to promote market transparency, and more closely tracks FINRA's approach requiring disclosures for same-day transactions.

II. FINRA's and MSRB's replacement of a size-based disclosure threshold with a retail customer standard better captures trades that are likely to most benefit from enhanced price disclosures.

In their initial proposals, FINRA and MSRB used a size-based requirement to trigger disclosure requirements, whereby disclosure would apply to a transaction with a customer to purchase or sell 100 bonds or less or bonds with a face value of $100,000. While we understood that such a size-based standard had the potential to be both over-inclusive, in that it might capture small institutional trades, and under-inclusive, in that it might not capture large retail investor trades, we still thought it was a reasonable approach to capturing those trades that are retail in nature and would most benefit from enhanced price disclosures. In our initial comments, we urged FINRA and MSRB to continue to monitor market activity in relation to the definition of "qualifying size" to determine whether that standard should be modified.

The revised proposal replaces the "qualifying size" threshold with a retail customer account standard. This strikes us as a better approach toward capturing trades that are likely to benefit most from enhanced price disclosures. Under the revised approach, all retail transactions will receive confirmation disclosures regardless of how large they are, and no institutional transactions will receive confirmation disclosures regardless of how small they are. This is an appropriate distinction for the purposes of this rule, as institutional investors are typically more sophisticated and better-informed than retail investors and, as a result, should already understand the transaction costs they are paying.

III. The proposed exemptions to the revised proposals are, by and large, reasonable, with a few exceptions. FINRA and MSRB must ensure that those exemptions are not used to evade disclosure obligations.

FINRA has proposed to allow firms the flexibility to establish a reasonable alternative methodology for determining the reference price when more complex trades are made. Under FINRA's proposed approach, if one or more intervening principal trades of a different size are made, firms have two options. They can employ the average weighted price of the firm trades that equal or exceed the size of the customer trade, or the price of the last same-day trade executed as principal by the firm prior to the customer trade (or closest in time if executed after). Further, the firm must consistently apply that methodology across the member's retail customer base and clearly document that methodology in written policies and procedures.

Allowing firms to choose between these options, but requiring firms to consistently apply whichever methodology they choose and clearly document that methodology in written policies and procedures, would constrain firms from adopting novel and complex methodologies on the fly that render their calculations meaningless, inaccurate, or deceptive. We urge FINRA to retain these requirements in its final rule, and we urge MSRB to adopt them as well, alongside its return to the

original approach proposed. Failing to do so would create a huge loophole, enabling firms to evade their responsibility to provide meaningful, accurate, and consistent price reference calculations.

FINRA has also proposed to allow firms to elect whether to disclose the reference price for transactions in which there are material changes to the price of a security or to disclose instead the reference price together with a statement explaining such price change. Under the proposal, firms could elect not to disclose after documenting and demonstrating that a material change has occurred.

It is not clear how this exemption would work in practice, first, because it's not clear what standard a firm would need to meet to document and demonstrate that a material change has occurred, and second, because "material change" is not defined. The only guidance that is provided is that this provision could be used when there is a material change in the market price, due to, for example, a credit downgrade or breaking news regarding the obligor, and that this exemption is not intended to be used when the price of the security has changed due to normal price fluctuations or general market volatility. While a credit downgrade is a concrete occurrence that is not likely to occur with regularity, it is not clear what would qualify as breaking news. Given that we live in an era when constant Twitter updates can affect companies' and municipalities' securities prices, it could be too easy for firms to make a colorable argument, based on any breaking "news source," that a material change to a price has occurred, in which case the firm could avoid its disclosure obligations.

Instead of attempting to determine what standard a firm would need to meet to document and demonstrate that a material change has occurred and define what constitutes a "material change," we urge FINRA to require disclosure in all instances in which there is a material change to the price of a security. If firms wish to provide clarifying information with that disclosure explaining the material change in price, they are free to do so. Our suggested approach would address firms' stated concern that disclosing reference prices during volatile trading days might cause investors to be confused about the prices they see. Our suggested approach would also address another concern that firms have expressed previously, that providing disclosure in some cases but not in others would also lead to investor confusion.

FINRA and MSRB have also proposed to exclude from the proposed disclosure requirements trades that are conducted by a department or desk that is functionally separate from the retail-side desk. FINRA's description of this exemption states that, to qualify for the exemption, the firm must demonstrate through policies and procedures that the firm-side transaction was made by an institutional desk for an institutional customer that is separate from the retail desk and the retail customer. We strongly support this language, as it will help to ensure compliance. However, the policies and procedures language does not appear to be incorporated in the rule language. Considering similar policies and procedures language is incorporated in the rule text relating to firms' establishment of reasonable alternative methodologies, we think it would be helpful to eliminate this ambiguity by adding the policies and procedures language to the rule for the functionally separate desk exemption as well.

MSRB uses the same functionally separate language, but does not define what that means or require firms to demonstrate through policies and procedures that a non-retail desk is indeed functionally separate. We urge MSRB to add policies and procedures language that tracks the language FINRA uses in its description of the exemption. MSRB also has a requirement that the functionally separate principal trading desk through which the dealer purchase or sale was executed had no knowledge of the customer transaction. It's not clear how anyone could ever prove that a

trading desk had no knowledge of the customer transaction, as it would require proving a negative and divining a desk and its traders' states of mind. We urge MSRB to eliminate this requirement. Replacing it with the policies and procedures language will better ensure firms' compliance and regulators' review of firms' compliance.

Conclusion

It is long overdue that firms provide essential cost disclosures to retail investors in fixed income markets. The fact that many firms currently don't provide that information and have so strongly opposed regulatory efforts to require providing it reflects their interest in preserving an opaque market that allows them to extract rents from their less well-informed retail customers.

FINRA's revised approach would fundamentally change this troubling dynamic by requiring firms to provide critical confirmation disclosures to their retail customers. It would result in retail investors' receiving more and better disclosure that would allow them to make better informed investment decisions, and it would foster increased price competition in fixed income markets. In contrast, it is not clear MSRB's revised approach would fundamentally change current market dynamics, as it would allow firms to easily evade their confirmation disclosure requirements. If firms do take advantage of loopholes in the MSRB rule to evade their obligations, retail investors will be no better off than they are currently. We urge MSRB to reconsider its approach and return to a rule that closely tracks FINRA's. And, for all the reasons explained above, under no circumstances should FINRA adopt an approach that tracks MSRB's reproposal.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel