BDA Bond Dealers of America

21 Dupont Circle, NW • Suite 750
Washington, DC 20036
202.204.7900
www.bdamerica.org

January 20, 2015

VIA ELECTRONIC MAIL

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

RE: **FINRA Regulatory Notice 14-52: FINRA Requests Comment on a Proposed Rule Requiring Confirmation Disclosure of Pricing Information in Fixed Income Securities Transactions**

Dear Ms. Asquith:

On behalf of the Bond Dealers of America ("BDA"), I am pleased to submit this letter in response to the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 14-52 (the "Notice"), requesting comment on a proposed rule to require the disclosure of pricing reference information on trade confirmations for certain 'retail-size' fixed-income securities transactions. BDA is the only DC based group representing the interests of middle-market securities dealers and banks focused on the United States fixed-income markets and we welcome this opportunity to present our comments on the Notice.

BDA is concerned that regulators may move forward with this pricing reference disclosure rule without fully appreciating the complexity of the proposal from an operational and systems standpoint and without first engaging in a study that would inform regulators about the potential for this proposal to cause harm and confusion to investors, dealers, and the marketplace. Therefore, BDA urges regulators to engage in a feasibility study in order to begin to explore the inherent complexities of the proposed rule. Importantly, the feasibility study will create a valuable opportunity for regulators, dealers, and investors to explore enhancements to EMMA and TRACE that would serve as a cost-effective alternative to the disclosure described in the proposed rule.

BDA supports measures to increase pricing transparency for retail fixed-income investors. However, BDA is extremely concerned by the fact that the Notice lacks any discussion of how the proposed rule will actually function in the context of the systems currently used by dealers. While the description of the rationale that governs the disclosure methodology is clear what is not explored in the Notice is how difficult and

costly it will be for dealers to integrate this logic into their various trading and operational systems. Dealers will have to make alterations to operations, technology, clearing, and trading systems, in addition to third-party-vendor-provided services. The cost burdens associated with these changes will be significant for dealers, especially small-to-medium sized dealers. The Notice fails to fully contemplate these changes or their associated costs.

Without a full discovery of these complexities and the rule's possible negative investor impacts, preparing a comprehensive economic and operational analysis of the rule's impact is impossible. If, after completing a full discovery process, regulators chose to re-propose the pricing reference disclosure rule rather than working to create alternative solutions through enhancements to the functionality of EMMA and TRACE, regulators should allow for an additional comment period.

The proposed rule lacks a discussion of the various operational and technology obstacles for accurately capturing specific trade details for a specialized universe of trades, listing that information on a confirmation, and delivering that confirmation to the customer.

The Notice describes the logic that will be used to identify a universe of trades that will require a special confirmation disclosure. However, the rule does not discuss how FINRA and MSRB—based on their understanding of the trading, operational, and clearing systems currently used by dealers—believe it is feasible for dealers to seamlessly integrate the proposed rule's logic into their current systems in order to accomplish what is described in the Notice or what the associated cost burdens of doing so could be.

Listed below are some of the most significant and costly changes dealers will have to make in order to comply.

- Dealers will have to build new systems designed to capture the rule's required data elements in front and back-end systems.
- Dealers will be required to re-design front-end trading systems and back-office Service Bureau systems to operate with new matching logic. This system will need to be designed to run in real-time and will link dealer activity with customer trading activity. (This aspect of the rule will be especially problematic for firms, especially when applying the logic in real-time while executing significant buying and selling of securities at a variety of sizes and prices. For smaller firms, that may have to perform these types of tasks manually this could present a devastating technology and compliance burden. In some cases, smaller firms depend on vendors who may not even be willing to perform the tasks.)
- Dealers will have to design systems that work with batched trade files to identify—on a CUSIP-by-CUSIP basis—principal trades and associated retail trades. Then, at the end of the trading day, the system will have to apply the proper LIFO, closest in time, or average price methodology (based on FINRA's currently proposed rule) depending on how the principal position was accrued and the aggregate quantities of the retail-size trades. This is a system that does not

currently exist.

- Dealers may have to completely re-design their trade confirmations in order to comply with the rule's requirements. Trade confirmations have limited physical space to display the disclosures currently required under existing, applicable confirmation disclosure rules. Adding yet another required disclosure element will further challenge the finite confirm space availability, and at some point will yield diminishing returns to the investor as a disclosure piece due to the volume of information presented and the manner in which it must be presented to fit in the physical space.
- Trade files and reports will have to be enhanced in order to supervise compliance with the proposed rule change.
- Dealers will have to engage various third-party vendors to design solutions that will work in tandem with the various third-party-provided services and systems dealers currently use.

BDA believes that the proposed rule's universe of associated principal and retail trades is too broad and is not based on any empirical, market-based analysis.

BDA believes that, as currently designed, the rule would require disclosures that may not convey useful or complete information to retail investors. BDA believes that retail investors will ultimately ignore a disclosure that is confusing and applied without understandable consistency.

As Example 3 on page 4 of FINRA's Notice describes the reporting obligation for a firm that enters into a trade, in a principal capacity, to buy 500 bonds for 100 per bond. Then, on the same trading day, the dealer sells 30 of those bonds in a retail-sized transaction for 102.5 per bond. As the example states, the proposed rule would require a price differential disclosure of 2.50 on the retail trade confirmation.

This proposed disclosure requirement would inform the retail investor of the same-day price reference associated with the 30-bond purchase. But, this disclosure would not create a complete picture of the risks associated with this trade. The disclosure fails to provide the retail investor with a comprehensive disclosure because it does not adequately capture a holistic picture of the market risks and costs to the dealer for continuing to carry $469,250 of bonds in inventory for an undetermined period of time.

In this instance, if the retail customer scrutinized their dealer-provided trade confirm they would see the 2.50 ($750) pricing differential. However, the retail investor would be unaware that the dealer still held 94% of the original principal transaction in inventory. Carrying inventory carries significant risks. Profits are not guaranteed for the dealer. Dealers accept these risks in order to earn reasonable compensation in the service of their retail customers. BDA rejects the notion that principal trades entered into by dealers who chose to use their limited balance sheet capacity to service potential customer demand in the future are "riskless." These trades are not the functional equivalent of agency trades and should not be treated as such. BDA is concerned that this

disclosure could give investors the false impression that these trades are "riskless" thereby reducing investor confidence in the marketplace.

Furthermore, compensation, earned in compliance with the dealer's best execution responsibilities, helps to pay for the costs including but not limited to operations, sales, compliance, and trading personnel, credit analysts, providing retail investors with trade confirmations, monthly, quarterly, and annual statements, CUSIP fees, and the cost of trading technology services. These risks and costs are not disclosed to the retail investor, which creates an incomplete and misleading reference for the retail customer and the dealer, especially when the dealer holds inventory for any period of time.

As FINRA's rule states, "FINRA has observed that over 60 percent of retail-size trades had corresponding principal trades on the same trading day. In over 88 percent of these events, the principal and customer trades occurred within thirty minutes of each other." If this timescale captures the vast majority of the universe of trades that regulators seek an enhanced disclosure in relation to, BDA urges regulators to provide an empirical, market-based rationale for why designing the disclosure to apply in a full-day trading range is their preferred methodology.

BDA believes the proposed rule will provide a disclosure that may confuse investors and will not enhance investor understanding of the market generally.

The Overview to MSRB's rule states: *"This potential disclosure, made in connection with the investor's transaction, may be significantly beneficial for the purposes of the investor's understanding of the market for the traded security."*

The Background and Discussion of FINRA's rule states: *"FINRA has also observed that while many of these trades have apparent mark-ups within a close range, significant outliers exist, indicating customers in those trades paid considerably more than customers in other similar trades."*

The quotes above both allude to a comparative value analysis not between dealer cost basis and investor cost but, rather, between investor cost and the costs of other investors entering into "similar trades" in the market during a similar timeframe—"the market for the traded security."

Prices in the fixed income market are dynamic. A dealer may purchase bonds at 99 in a principal capacity prior to a market-moving event and then enter into a sale, possibly hours after the initial transaction, at a 102 in full compliance with the dealer's best execution responsibilities. At that point, another dealer could be executing comparable retail-size sales at 102.5 or 103 with a cost-basis (for disclosure purposes) of 101.

BDA notes that the disclosure—by definition—is based on where the market was rather than on the actual market conditions at the time of the executed trade. This creates

the opportunity for a highly misleading disclosure. In this instance, the dealer that filled the customer order at the superior market price will be required to disclose a larger markup than the dealer that filled the customer order at the inferior price. The potential impact on the market that could be caused by providing this misleading information to investors is currently unknown and should be studied fully for the benefit of investors and the marketplace.

Furthermore, BDA notes, that if the disclosure were required to be based on LIFO, average price, or the closest in time standard depending on trade size and how the dealer accrues the principal position, three identical retail-size investor trades would receive three completely different pricing reference disclosures which adds an additional layer of potential confusion for investors.

BDA strongly recommends that FINRA and MSRB engage in a feasibility study to discover and evaluate the various practical challenges this highly complex rule presents.

Due to the fact that the proposed rule does not contain a discussion of what the proposed rule would entail from a technology and operational standpoint, BDA recommends FINRA and MSRB develop a feasibility study to explore what the optimal method for providing investors with greater market transparency could be. BDA is especially concerned with how this proposed rule will impact the competitive position of small-to-medium sized dealers. As stated above, BDA urges regulators to resubmit the pricing reference disclosure rule for comment after engaging in a comprehensive feasibility study.

Furthermore, as part of the study, BDA urges FINRA and MSRB to seek the input of the third-party vendors that dealers rely on to provide trading, technology, accounting, operations, and clearing services. While FINRA and MSRB are not required to perform outreach to these critical providers of services to dealers, the success of this rule will ultimately depend on the ability of these service providers to work with dealers and to configure their systems to allow efficient implementation and compliance to occur.

As BDA discussed above, FINRA and MSRB have not fully explored what this rule means for dealers on a practical day-to-day basis. The discovery process engendered by a feasibility study will allow for an assessment of what this rule would actually mean from an operational, technology, and trading systems standpoint. This will allow regulators to have greater insight into the systems on which they have proposed dealers make significant alterations. Additionally, BDA suggests FINRA and MSRB to actively seek the expertise of clearing firms and third party technology vendors to assess the feasibility of the rule and to discuss the operational and technological obstacles to expeditious dealer compliance.

This study should also provide an opportunity to explore ways to enhance TRACE and EMMA and explore why investors are not accessing these websites to evaluate the comparative value of their trades compared to similar-sized trades executed

in the market during similar timeframes. This study presents an opportunity for regulators to engage with investors and dealers in order to enhance EMMA and TRACE rather than requiring an additional disclosure prior to understanding why investors routinely ignore, or fail to seek, the market data that would naturally enhance their understanding of the market.

BDA suggests allowing dealers to employ whichever pricing disclosure methodology is the most efficient, least-cost method that fully complies with the dealer's responsibilities under the proposed rule.

If, after competing a comprehensive feasibility study, FINRA and MSRB present a detailed, market-based justification for why implementing a rule similar to the proposed rule is optimal for investors and the market, BDA recommends that FINRA allow dealers to choose the disclosure methodology of their choice. This will allow dealers to utilize the disclosure methodology that works most effectively with their existing systems. Dealers should be allowed to disclose the price differential in percentage spread, dollar terms, price differential, or yield terms. From a cost accounting standpoint, dealers should likewise be able to assess the functionality of their current systems and chose to make the reference disclosure using a weighted average, LIFO, FIFO, or closest in time proximity depending on what method works with their existing system capabilities.

The rule should contain some exclusions.

The rule should not apply to institutional investors. The rule operates to protect mainly retail investors through its application only to small trade sizes. The rule, though, should specifically exclude coverage to institutional investors so that dealers are able to categorically exclude those trades from coverage.

The rule should specifically exclude trades in connection with primary offerings. Distributions in connection with primary offerings benefit from offering memoranda that offer ample disclosure concerning the offering. Accordingly, trades by dealers in connection with distributions of securities in connection with primary offerings should be excluded from the coverage of the rule.

Thank you again for the opportunity to submit these comments.

Sincerely,

Michael Nicholas
Chief Executive Officer