Murky Finra markup rule may get murkier

Finra wants to replace its long-standing 5% policy with principles-based guidelines

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In a move that could affect what broker-dealers charge clients for securities transactions, Finra this month proposed dropping its long-standing 5% markup/markdown policy.

The proposed regulation — which would roll up several NASD and New York Stock Exchange markup rules into one consolidated rule — incorporates existing factors firms are supposed to use in determining fair trading costs. Those include a security's liquidity, price and size of the transaction.

The markup rules would apply largely to trades in which broker-dealers acted as a principal, or bought and sold securities from inventory to meet customer demand. The fixed-income market is largely dealer-based, as is the market for smaller, illiquid stocks.

Commissions on the majority of equity transactions are so competitively priced that they fall below the 5% ceiling in most cases.

The Financial Industry Regulatory Authority Inc.'s principles-based approach to changing the ceiling probably won't sit well with the many B-Ds that have been clamoring for more-specific information on what constitutes fair commissions and markups.

“The real issue is going to be how Finra enforces” the revised rule and the factors it considers, said Dave Paulukaitis, managing director of Mainstay Capital Markets Consultants Inc. and a former Finra official.

“Firms will have to be a lot more sensitive as to charges for trades, and be ready to defend them,” he said.

A firm might be able to defend a 5% charge, but “arguably [with the proposed rule], you've got to be ready to defend every transaction,” Mr. Paulukaitis said.

Brokerages are sure to make that point in the comment period for the proposal, which ends March 28. But Finra defends its proposal, noting that many brokers take the current rule to mean that any customer charges under 5% wouldn't be challenged.

In reality, Finra said, the policy is intended to serve as a warning that charging customers more than 5% on a trade is likely to be deemed excessive. In that sense, the 5% policy is more rule of thumb than a hard and fast rule.

What's more, Finra points out that the policy is “based on the execution practices and market efficiencies of nearly 70 years ago.”

According to some, an updating is long overdue.

“I think it's a very good thing [for Finra] to finally come out and say that there's [no more 5% policy],” said Elizabeth Baird, a partner at Bingham McCutchen LLP and a former bond trader. “In lots of ways, it's been gone for a while,” she said, because examiners question charges well under the 5% maximum guideline.

“I've seen [Finra] attack a 3%” markup, said Robert Beers, an industry attorney and compliance consultant at the law firm Robert C. Beers PC. He would like to see more guidance from Finra regarding transaction costs.

Determining what is excessive “can come down to a gut feeling” by Finra as to what is proper, Mr. Beers said. The rulemaking notice “may be an opportunity for commentators to force them to be more precise,” he said.

In a 2007 study of low-priced over-the-counter stocks ($5.50 a share, on average), an independent consultant found the mean markup to be 2.2% and the median markup to be 2%, the Finra release stated. Markdowns were even lower: The mean markdown was 1.9% and the median was 1.3%.

The 5% policy does come up in some investor arbitration cases, said plaintiff's attorney Peter Mougey, a shareholder at Levin Papantonio Thomas Mitchell Echsner Rafferty & Proctor PA and president of the Public Investors Arbitration Bar Association.

He supports dropping the 5% guideline but thinks that “enforcing the principles-based proposal is a monumental task” for Finra.

In a notice to members, Finra said that for the time being, it has decided not to set a new, lower percentage as a guideline, “as this may encourage members to artificially peg (or cap) their markups, markdowns and commissions based upon the new percentage.”

But in a footnote, Finra said that it expects to provide guidance about what percentage charge would require justification from member firms.

Bond trades are particularly open to being questioned, observers said.

In routine exams and quarterly sweeps, Finra often inquires about fixed-income trades going back several years, Ms. Baird said, with firms often challenged to justify a markup or markdown.

The proposed rule doesn't say that a trade should be within a certain percentage of other trades at the time, she said, “but that's the way [examiners] look at [bond trades] in these sweeps.”

Some enforcement actions by regulators have indicated that a 3% or lower charge might be appropriate, Ms. Baird said. “But Finra has never actually said that” in its rules or guidance, she said.

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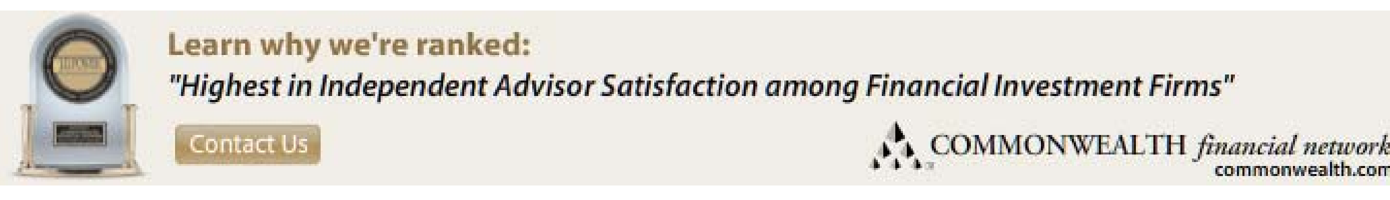

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