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## **MSRB Proposes Historic Dealer Markup Disclosure for Retail Investors.**

WASHINGTON - In an historic action, the Municipal Securities Rulemaking Board has filed a markup disclosure proposal with the Securities and Exchange Commission that MSRB said will likely lower transaction costs for retail investors, enable them to better understand dealers' pricing practices, and improve investor confidence in the municipal market.

The proposal to amend rules G-15 on confirmation and G-30 on prices is similar to one that the board released in September, but includes a few changes as well as the MSRB's robust defense of why muni markup disclosure is needed.

The proposed rule changes would require a dealer, which buys or sells munis for or from its own account to a retail customer and engages in one or more offsetting transactions on the same trading day in the same security, to disclose its markup and markdown in the confirmation they send the customer.

The rule filing with the SEC also includes guidance for dealers on how to establish the prevailing market price of a municipal security in order to calculate their compensation.

If approved by the SEC, the proposed rule changes would take effect no later than one year afterwards, the MSRB said.

The board told the SEC in the filing that the proposal "would provide retail customers with information similar to that currently received by retail customers in equity trades and muni trades in which the dealer acts in an agent capacity (on behalf of the customer).

The proposal also would "enable customers to evaluate the costs and quality of the execution service that dealers provide ... improve communication between dealers and their customers, and make the enforcement of Rule G-30 more efficient," the MSRB said.

"The concept of providing this type of transparency of transaction costs for municipal securities was first floated 40 years ago," MSRB executive director Lynnette Kelly said in a release. "Changes in technology and in the municipal market have made it possible for investors to receive similar transaction information as investors in the equity market. This is a meaningful and historical shift for the municipal market."

"Our proposal will provide dealer compensation information on an estimated 8,000 retail investor municipal securities transactions each day," Kelly said. "That's a significant number of people who will have additional information about the cost of their transactions."

Dealer groups, firms and some issuers had complained the proposed rule changes would add complexity to the market and be burdensome and costly.

But the MSRB told the SEC that it believes the benefits of markup disclosure far outweigh any

burdens to issuers.

The board said it “recognizes that some dealers may exit the market or consolidate with other dealers as a result of the costs associated with the proposed rule change relative to the baseline.”

But it added that it, “does not believe — and is not aware of any data that suggest — that the number of dealers exiting the market or consolidating would materially impact competition.”

The MSRB provided evidence from a survey of pricing data on its EMMA system that it said buttresses its contention that this kind of muni market disclosure is needed.

It analyzed various data reported to EMMA by dealers from July 1, 2015 through September 30, 2015 and found the average daily number of retail-size customer transactions in the secondary market for munis in which dealers acted as principals was 15,538.

About 700 firms reported trades during the period but the top 20 with the highest volumes accounted for about 73% of the muni trades.

The MSRB found that of the retail-size customer trades in which dealers acted as principals, about 55% would have likely received markup and markdown disclosures had the rule had been in place. Of those trades, 83% of the offsetting trades occurred within 30 minutes.

For those trades where they would have been markup and markdown disclosure, the estimated median markup value was 1.2% and the median markdown value was 0.5%. The MSRB found that “many customers paid considerably more than the median value,” with at least 5% of them paying markups higher than 2.25%. At least 5% of customer sales had markdowns higher than 1.51%.

The board also said that joint investor testing by the Financial Industry Regulatory Authority and the board revealed that investors do not understand how dealers are compensated when they act in a principal capacity and that investors want more information on this topic.

The biggest change from the proposal released in September to the one filed with the SEC is that the MSRB decided the markup disclosure requirement would be triggered if the offsetting transaction occurred on the same trading day rather than over a two-hour period.

The MSRB kept the same three exceptions. Markup disclosure would not be required: if the offsetting trade is done by a functionally separate trading desk; for primary market trades at the list offering price; and for municipal fund securities.

For a muni trade subject to markup disclosure, a dealer would have to calculate the markup under Rule G-30 and related guidance and express the markup as both a percentage of the prevailing market price and a total dollar amount. The dealer would also have to provide a reference or hyperlink to the “security details” for the muni on EMMA, along with a brief description of the type of information available on that page. The dealer would also have to provide the time of execution.

The proposed changes to Rule G-30 and related guidance state that a dealer ‘must exercise “reasonable” diligence in establishing the market value of a security and the reasonableness of the compensation received.’ Also, the markup or markdown “must be a fair and reasonable amount, taking into account all relevant factors.”

Rule G-30 already prohibits dealers from engaging in principal transactions with customers except at aggregate prices (including any markup or markdown) that is fair and reasonable, the MSRB noted.

The changes to Rule G-30 show how to establish the prevailing market price, upon which a dealer's costs and markup or markdown is determined. The dealer's compensation would be the amount it charges over the prevailing market price when selling bonds and the difference between what it pays and the prevailing market price when buying bonds.

The MSRB proposes a "waterfall" or hierarchy of factors that dealers should look at in establishing the prevailing market price of a muni.

First, dealers should look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of prevailing market price. The prevailing market price should not differ if the dealer trade is with another dealer or a customer.

If the dealer believes contemporaneous trades are not representative of market value, they can rebut the presumption that they determine the prevailing market price by showing changes in interest rates, changes in the credit quality of the debt, or news that has changed the market's perception of the market value of the security.

If the dealer does not have any contemporaneous trades of the muni security, it can look at contemporaneous trades of the muni security among other dealers. If it finds none, it can look at trades of that muni security between other dealers and institutional investors with which the dealers regularly trade that same security. If there are none, the dealer can look at alternative trading systems, or other electronic platforms, where trades occur at displayed quotations.

If there are no contemporaneous trades in the muni security or quotes for it, the dealer can look at contemporaneous trades of similar securities. A muni security would be similar if it had a comparable yield. Other "non-exclusive factors" that can be used to determine similarity include: credit quality; the extent to which there are comparable spreads; general structural characteristics and provisions of issue; the size of the issue, the float or recent turnover of the issue and legal restrictions on transferability; and comparable federal and/or state tax treatment.

If these factors cannot be used to find similar securities, dealers can consider prices or yields derived from economic models, the MSRB said.

The board cautions dealers against relying on isolated transactions or quotations, saying they should be given little or no weight in establishing the prevailing market value or price.

Dealer groups are still concerned about the proposal's complexity.

John Vahey, director of federal policy of the Bond Dealers Association said that while "BDA accepts the premise that retail investors may benefit from greater information on transaction costs, we urge regulators to more fully appreciate the operational complexity of the proposed rule and the significant difference between establishing prevailing market price in the context of fair pricing and creating an automated operational process that computes prevailing market price for inclusion on a customer confirmation."

"Dealers, especially smaller dealers, will need at least 18 months to develop and test new systems designed to comply with the rule, especially with other significant effective dates, including the Department of Labor's fiduciary duty rule, fast approaching," he said.

Leslie Norwood, a managing director and co-head of the muni division at the Securities Industry and Financial Markets Association said, "We are reviewing the proposal and will send a comment letter to the SEC. At first glance, it appears to be substantially similar to the FINRA filing. We believe there are significant implementation and operational issues that will likely require additional

guidance.”

## **The Bond Buyer**

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