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Dealers to SEC: Markup Proposal Overly Complex, Would Hurt Liquidity.

WASHINGTON – Dealer groups are warning that a Municipal Securities Rulemaking Board proposal to require dealers to disclose their markups and markdowns in certain transactions would be overly complex and hurt liquidity.

They urged revisions and new guidance allowing for compliance through dealers' automated systems.

The groups made their comments to the Securities and Exchange Commission regarding the MSRB's proposed changes to its Rules G15 on confirmation and G30 on prices.

The 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 markups and markdowns in the confirmation it sends the customer.

The Financial Industry Regulatory Authority has proposed a similar requirement and has been coordinating its changes with the MSRB.

The MSRB proposal, filed with the SEC on Sept. 2, also establishes a waterfall of factors for determining prevailing market price (PMP), which dealers would then use to calculate their compensation. Dealers would initially look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of prevailing market price. They would then make a series of other successive considerations if that data is not available. They can look at contemporaneous trades of the muni in interdealer trades, then trades of the muni between other dealers and institutional investors, then trades on alternative trading systems or other electronic platforms.

Further down the waterfall, firms could look at contemporaneous trades of similar securities.The MSRB included a list of "non-exclusive factors" like credit quality, size of the issue, and comparable yield that could be used to show securities are similar.

The bottom of the waterfall allows dealers to use prices or yields derived from economic models.

Both Bond Dealers of America and the Securities Industry and Financial Markets Association criticized the proposed waterfall of considerations given, among other things, the level of subjectivity many of the determinations would require.

BDA chief executive officer Mike Nicholas said the proposal "vastly underestimates the complexity of operationalizing the waterfall concept in an automated fashion."

"In light of the fact that there is currently no commercially available solution for automating the waterfall process … dealers will have to devote significant resources to finding a solution that works with their existing legacy systems and processes," he wrote.

Leslie Norwood, managing director and co-head of municipal securities for SIFMA, and Sean Davy, managing director for SIFMA's capital markets division, warned that under the proposal dealers that carry inventory would be required to "grapple with the cost and complexity" of such programming. They said that the burden could cause those firms to move to a riskless principal model "rather than assume the costs, complexities, and risks of implementing the proposal as currently formulated."

"Unfortunately, there is no suggestion that the MSRB has measured or fully considered the risk that its proposal will impair liquidity in the municipal market," SIFMA wrote. "A more thorough analysis of the proposal's effect on liquidity is entirely within the MSRB's capabilities."

SIFMA, which also made clear that working with the MSRB's EMMA system and FINRA's TRACE system would be a more effective way to ensure investors are informed, asked that the MSRB adopt explicit guidance recognizing that it is not technologically feasible to automate a strict waterfall analysis. The prevailing market price analysis should also only apply to the confirmation disclosure proposal instead of transactions in general, SIFMA said.

Quoting a section of the SEC's 2012 Report on the Municipal Securities Market that explained determining the prevailing market price for munis can be a complex task, Norwood and Davy said the complexity would be "further amplified in the context of the proposal."

"The MSRB should expressly recognize this operational reality and provide further guidance regarding what it views as 'reasonable policies and procedures' to calculate PMP on an automated basis," SIFMA said. The group suggested that the self-regulator allow firms to adopt an alternative to contemporaneous costs or proceeds, such as pulling prices from third-party pricing vendors.

Additionally, SIFMA is asking that the MSRB and FINRA acknowledge that firms would be acting reasonably and appropriately by labeling their markups and markdowns as an "estimate" or as "approximate" on the confirmations given the difficulty of being exact when using the waterfall. Nicholas also said that it would be appropriate to deem the disclosed markup or markdown as a dealer's estimated compensation.

Regulators should acknowledge that firms may diverge when determining what securities are "similar," given the likely subjectivity of the determination and its basis on facts and circumstances, SIFMA wrote. The group wants an assurance that regulators would not find that a dealer's calculation is incorrect as long as it is based on a reasonable and good faith automated measure of PMP based on the information available at the time of the transaction.

Both dealer groups asked for clarifications on certain aspects of the MSRB filing.

BDA expressed "serious concern" that the proposal says isolated transactions in munis "may" be given little or no weight in establishing prevailing market price. Nicholas notes that munis do not trade as frequently as corporates and that given the specificity of the required similar security analysis, isolated securities or those with a limited number of trades may be the only ones a dealer could deem similar.

He added that there is a discrepancy between the MSRB's filing and the actual rule text as to how much weight an isolated transaction can be given. He requested the board clarify the language as well as the intent of the section.

SIFMA asked that the MSRB revise its guidance to more accurately describe what it means by a spread, which is included in its non-exclusive list of relevant factors, to determine whether a security is similar. The example the board gives of a spread compares munis to Treasuries, but only taxable

munis trade at a spread to Treasuries, SIFMA said.

Both BDA and SIFMA also emphasized the need for the MSRB to coordinate their rulemaking with FINRA as much as possible to limit the compliance burden. The MSRB has proposed dealers send customers security-specific hyperlinks along with confirmations. The groups said it would be better for the board to require dealers to include more general links on confirmations that would direct customers and investors to pages on which they can search for their specific securities. The two dealer groups also asked the MSRB and FINRA to set a more reasonable implementation period than the proposed one year after SEC approval. They cited the complexity of complying with the changes as well as the numerous other large regulatory developments that are expected soon, such as movement to a T+2 settlement cycle and implementation of the Department of Labor's fiduciary standard.

BDA asked the period be at least two years after SEC approval while SIFMA said that, if the MSRB and FINRA work to provide more clarity and guidance on the proposal, it could be implemented in no less than three years.

"Neither the MSRB nor FINRA have provided justification for such an aggressive timeframe," SIFMA said. "We urge [the regulators] to propose a reasonable implementation period consistent with the commission's expectations."

The Bond Buyer

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