

Bond Case Briefs

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MSRB Instructs Dealers to Disclose Existence of Market Discount in Municipal Bond Transactions: Chapman and Cutler

Client Alert

The Municipal Securities Rulemaking Board (“MSRB”) recently issued an interpretive notice announcing its interpretation that if a dealer engages in a transaction with a customer in a municipal security that bears market discount, the dealer must disclose the existence of market discount to its customer as part of the “time of trade disclosure” required under MSRB Rule G-47. Rule G-47 already includes original issue discount (“OID”) in the rule’s non-exhaustive list of information that may be material and require time of trade disclosures to a customer. Both market discount and OID impact the tax treatment of municipal bonds and can be particularly relevant for “tax-exempt” municipal bonds. The MSRB notice is available [here](#).

MSRB Rule G-47

Rule G-47 requires brokers, dealers and municipal securities dealers (collectively, “dealers”) to disclose to their customers, at or prior to the time of a municipal bond trade, all material information known about the transaction, as well as material information about the security that is reasonably accessible to the market. Information is considered to be material under Rule G-47 if there is a substantial likelihood that the information would be considered important or significant by a reasonable investor making an investment decision. The rule currently includes a non-exhaustive list of information that is generally considered material, including OID and other factors. While market discount is not listed in the rule, the MSRB interpretation now puts dealers on notice that the MSRB believes the existence of market discount to be an issue that is required to be disclosed to a customer under Rule G-47 at or prior to the time of trade.

Why is Market Discount and OID Disclosure Relevant?

Generally speaking, accretion of OID over the life of a tax-exempt municipal bond is treated as tax-exempt interest under federal tax law while market discount is taxable income at a taxpayer’s ordinary income tax rate (i.e., not as tax-exempt interest or at the capital gain rate). On the other hand, both OID and market discount are generally treated similarly to taxable interest income for taxable municipal bonds and are taxed at a taxpayer’s ordinary income tax rate. These factors can impact an investor’s decision to buy or sell a bond and the assessment of the bond’s price. Tax treatment and computation of OID and market discount is very complex. Investors and dealers should consult their tax advisors for complete information.

Why is the MSRB Concerned with Market Discount Now?

The recent steep rise in municipal bond yields appears to be behind the MSRB market discount disclosure guidance and also has initiated other recent MSRB action. The MSRB recently issued a statement cautioning investors about the potential risks to bond positions and bond portfolios

related to rising interest rates. The MSRB also recently submitted a letter to the Securities and Exchange Commission Investor Advocate on potential risks to retail investors in the municipal market, disclosure practices, price fairness and transparency, types of ownership of municipal bonds and senior investor protection as areas of particular concern. The MSRB letter is available [here](#).

The MSRB is concerned that an investor might not be aware that all or a portion of his or her investment return represented by accretion of market discount is taxable as ordinary income. The MSRB is concerned that this might result in an investor purchasing securities at an inappropriately high price (i.e., a price not reflecting the potentially higher tax rate applicable to the discount). The existence of market discount might also impact an investor's decision to purchase or sell a bond or determination of what price to pay or accept for a bond. As a result, the MSRB is now notifying dealers that it believes the fact that a security has market discount is material information that is required to be disclosed to a customer under Rule G-47.

What Should Dealers Do Now?

Dealers should review their existing policies and procedures to ensure that financial advisors disclose the existence of market discount to applicable customers in connection with municipal security transactions. Note that firms do not have any time of trade disclosure obligation under Rule G-47 with respect to customers that are sophisticated municipal market professionals, or SMMPs, as defined in MSRB Rule D-15.

November 29, 2016

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