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Initial Support for MSRB Pricing Guidance Proposal.

WASHINGTON – Challenges remain despite initial favorable reaction to a proposal to establish guidance for municipal securities dealers calculating prevailing market price and compensation in principal transactions, say dealers and members of industry groups.

The Municipal Securities Rulemaking Board's guidance, designed to harmonize MSRB standards with those previously established by the Financial Industry Regulatory Authority, was released on Feb. 18 in the form of amendments to MSRB Rule G-30 on prices and commissions. FINRA's guidance took effect in 2007 and currently applies to corporate debt and Treasury securities.

While the board felt FINRA's guidance, which took the Securities and Exchange Commission ten years to approve, was a good starting point, it emphasized that its own guidance would account for the unique aspects of the muni market.

The MSRB's solicitation of comments on establishing the prevailing market price for principal transactions is viewed as a precursor to rule changes that would require dealers acting as principals to disclose to retail customers the markups and markdowns on muni trades.

Leslie Norwood, a Securities Industry and Financial Markets Association managing director and co-head of munis for SIFMA, said the group is pleased the MSRB is recognizing there must be differences in how it applies the guidelines to the municipal market. The markets for many municipal securities "are diverse, fragmented and localized, and determining the market price of securities that trade infrequently can be challenging," she said. SIFMA plans to file more detailed comments on the proposed guidance in the coming weeks because the proposal will "likely have a material effect on the MSRB's pending confirmation disclosure proposal," according to Norwood.

Mike Nicholas, Bond Dealers of America's chief executive officer, said BDA appreciates "this logical next step" from the MSRB and believes that "achieving full harmonization of the FINRA and MSRB proposals is an essential component of any future retail confirmation rule."

Hutchinson, Shockey, Erley & Co. president and chief executive officer Thomas Dannenberg said he plans to think about the proposal further but appreciates the value of consistency and harmonization between regulatory standards. However, while he believes the MSRB is cognizant of the needed differences for the municipal market, he does question "whether an overly forced attempt to harmonize will distort the uniquely distinct characteristics of trading and pricing in the municipal securities market."

The MSRB's guidance follows FINRA's in proposing a "waterfall" or hierarchy of factors that dealers should look at to determine the prevailing market price of a municipal security.

The hierarchy places an emphasis on contemporaneous trades in establishing the value of dealer costs and proceeds, but allows for alternatives if contemporaneous trades are not available.

Micah Hauptman, financial services counsel with the Consumer Federation of America, said that while he is still reviewing the proposal, he has questions about whether dealers will be able to game the calculations “in a way that is more favorable to them and may hide the true transaction costs investors are paying.”

The “waterfall” would first have dealers look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of a prevailing market price.

If the dealer does not believe contemporaneous trades are representative of the security, it can rebut the presumption that the trades determine the prevailing market price by showing changes in factors like interest rates, the credit quality of the debt, or news about the security or issuer that has changed the market’s perception of the market value of the security.

If the dealer does not have contemporaneous trades of the muni security, it must follow a specific order of steps. The first is to look at contemporaneous trades of the muni security among other dealers. If the dealer cannot find any, it can then look at trades of the security between other dealers and institutional investors with which the dealers regularly trade that same security. If there are no trades that fit that qualification, the dealer can then look at electronic platforms where trades occur at displayed quotations.

If there are no contemporaneous trades in the muni security or quotes, the dealer may look at contemporaneous trades of similar securities, which at a minimum would have a comparable yield. To see if a security is similar, the dealer would look at features, provisions, or technical factors that could affect the yield in the same way, such as credit quality, spreads, maturities, call dates, or tax treatment.

If none of the prescribed methods work, dealers could base their prevailing market price calculations on economic models that apply the “waterfall” concept and take into account such things as credit quality, interest rates, industry sector, maturities, and call provisions.

MSRB Rule G-30, where the “waterfall” provisions would be adopted, generally requires a dealer to buy munis for its own account from customers, or sell munis from its own account to customers, at an aggregate price that is “fair and reasonable.” The transaction price to the customer must bear a reasonable resemblance to the prevailing market price of the security. The dealer’s compensation in principal trades with customers must be computed from the interdealer market price prevailing at the time of the transaction.

THE BOND BUYER

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FEB 19, 2016 4:06pm ET