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## **SEC Approves MSRB's Markup Rule, Drawing Criticism From Dealers.**

WASHINGTON - The Securities and Exchange Commission has approved the Municipal Securities Rulemaking Board's proposal to require dealers to disclose their markups and markdowns in certain transactions, drawing criticism from dealers.

The SEC approved the proposal late Thursday along with a parallel one by the Financial Industry Regulatory Authority.

"The commission believes the establishment of a requirement that dealers disclose markups/markdowns to retail investors, as proposed, will advance the goal of providing retail investors with meaningful and useful information about the pricing of their municipal securities transactions," the SEC said in its approval order.

The commission added that the changes will promote transparency of dealers' pricing practices and potentially promote price competition among dealers.

Colleen Woodell, chair of the MSRB's board of directors, said the muni market "will gain an unprecedented level of transparency" when the new rule is put in place roughly a year and a half after the approval date.

"We have been working tirelessly to improve transparency for municipal bond investors and the changes set in motion today will allow them to assess their municipal bond transaction costs in a way similar to other markets," Woodell said.

The MSRB is amending its Rules G-15 on confirmation and G-30 on prices and commissions. The changes will 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 amendments also establish a waterfall of factors for determining prevailing market price, which dealers will then use to calculate their compensation. Dealers will 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 determine if securities are similar.

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

Bond Dealers of America and the Securities Industry and Financial Markets Association have consistently criticized the rule changes as overly complex and potentially harmful to market liquidity. The main dealer complaint is that it will be difficult to automate a compliance system to take into account the waterfall of factors.

John Vahey, managing director of federal policy with BDA, said that the group doesn't believe that regulators fully appreciate the extent to which automating the waterfall is "a serious and complex and costly project for dealers."

He added that the SEC's approval follows a recent MSRB letter that said liquidity is a risk to retail investors.

Vahey said complex and costly regulation is a contributing factor to the consolidation of dealers and thus liquidity concerns for the market, which already has 19% fewer dealers today than it did in 2012. The MSRB, in its filings on the rules changes, has acknowledged the possibility that the amendments could lead some firms to exit the market or merge with other firms.

Leslie Norwood, managing director and co-head of municipal securities with SIFMA, said the SEC's approval of the requirements represents a "monumental change" for dealers and a significant change for investors.

"Now the hard work begins, as the devil is in the details of implementing such a significant change," she said. "Over the next 18 months, our members will continue to work with the MSRB regarding necessary guidance on this historic new rule," particularly as dealers work on a number of compliance issues.

Despite the dealer complaints, the SEC concluded that the changes were reasonably designed to ensure their purpose "while limiting the impact of operational challenges for dealers." It added that it believes it is feasible to automate the determination of prevailing market price in accordance with the proposed MSRB guidance. The SEC also noted that the MSRB has said that the changes reflect the lowest overall cost approach to achieving a worthy regulatory objective.

In addition to the issues with automating the waterfall, dealers had also posed several other compliance-related questions to the MSRB.

The firms had asked about whether they could be allowed to disclose the markups or markdowns on a confirmation as "estimated" or "approximate" given the level of subjectivity involved in some levels of the waterfall. The MSRB said such labelling would not be allowed because it could suggest that the amount listed is unreliable and might diminish the value of having the markup listed. However, the board said dealers could include explanatory language or disclosures on the confirmations to give context or help investors understand how the markups were calculated.

Dealers also questioned how the changes applied to fair pricing determinations. The MSRB said that if a dealer that uses reasonable diligence to determine the prevailing market price of a muni in accordance with the MSRB's guidance discloses a markup based on that determination, it should generally be able to rely on that determination for fair pricing purposes.

The MSRB also acknowledged that different dealers can reasonably reach different conclusions as to whether securities are similar for use in the prevailing market price determination.

Dealers had also questioned whether the reliance on economic models at the bottom of the waterfall could include use of third-party pricing services. The MSRB said that while a dealer can choose to rely on third-party services, the dealer still keeps the ultimate responsibility to ensure the fairness

and reasonableness of a price and any markup or markdown under the prevailing market price calculation. The self-regulator also said that a dealer should have a reasonable basis to believe that the third-party pricing service produces evaluated prices that reflect actual prevailing to use it.

## **The Bond Buyer**

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