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MSRB's Markup Disclosure Requirements to Take Effect in May 2018.

WASHINGTON - Dealers will have until May 14, 2018 to get ready for requirements that they disclose their markups and markdowns in certain transactions, the Municipal Securities Rulemaking Board announced on Tuesday.

The requirements are the result of MSRB rule changes the Securities and Exchange Commission approved, along with parallel rule changes from the Financial Industry Regulatory Authority, on Nov. 17.

The effective date gives dealers approximately a year and a half to implement the changes necessary to comply with the revised rules. The MSRB had originally recommended a one-year implementation timeline. But dealers complained that they would be facing several other large undertakings during that time period, such as shifting to a two-day settlement cycle from the current three-day cycle, and would have trouble completing everything on time.

Bond Dealers of America said dealers should have been given at least two years to implement the rule while the Securities Industry and Financial Markets Association had pushed for at least three years.

The MSRB will hold a webinar on the rule changes on Jan. 12, 2017.

MSRB chair Colleen Woodell has said that the muni market “will gain an unprecedented level of transparency” when the rule changes become effective.

The changes are to MSRB Rules G-15 on confirmation and G-30 on prices and commissions. The amendments 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 in an amount that in aggregate equals or exceeds the size of the customer trade, to disclose its markups and markdowns in the confirmation it sends the customer. Markup disclosures will have to be given as a total dollar amount and a percentage of the prevailing market price.

There are three exceptions to the rule under which markup disclosure will not be required: an offsetting trade done by a functionally separate trading desk; primary market trades at the list offering price; and trades of municipal fund securities.

The amendments also establish a waterfall of factors for determining prevailing market price, which dealers are to use to calculate their compensation. Dealers initially are to look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of prevailing market price. They will 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 can be used to determine if securities are similar.

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

The main dealer complaint about the rule changes is that it will be difficult to automate a compliance system to take into account the waterfall of factors, with some saying the regulators do not understand the complexity and cost associated with implementing the changes.

The SEC said in its approval order that the MSRB’s changes were reasonably designed to ensure their purpose while limiting the impact of operational challenges for dealers. The commission also concluded that it is feasible for dealers to automate the determination of prevailing market price in accordance with the self-regulator’s guidance and that the changes reflect the lowest overall cost approach to achieving a worthy regulatory objective.

Under the rule changes, dealers will not be allowed to label their markups or markdowns on confirmations as “estimated” or “approximate” but can include explanatory language or disclosures on the confirmations to give context or help investors understand how the markups are calculated. The MSRB has 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 are allowed to rely on third-party services as part of their reliance on economic models at the bottom of the waterfall. However, the MSRB has said that if a dealer chooses to do that, it 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 Bond Buyer

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