MSRB Seeks Comment on Guidance on "Prevailing Market Price" for Municipal Bond Mark-Ups

The Municipal Securities Rulemaking Board (*"MSRB"*) is seeking comment on proposed guidance on establishing the "prevailing market price" and calculating mark-ups and mark-downs for principal transactions in municipal securities. The MSRB believes additional guidance on these subjects may promote consistent compliance by brokers, dealers and municipal securities dealers (*"dealers"*) with their existing fair-pricing obligations under MSRB and Financial Industry Regulatory Authority, Inc. (*"FINRA"*) rules. The MSRB's proposed guidance is generally consistent with the supplementary material to FINRA Rule 2121 regarding the establishment of prevailing market price for fixed income securities other than municipal securities. The full text of the proposed regulatory notice seeking comment can be found here.

Background

MSRB Rule G-30 generally provides that a dealer may only purchase municipal securities for its own account from a customer, or sell municipal securities for its own account to a customer, at an aggregate price including any mark-up or mark-down that is fair and reasonable. Under MSRB Rule G-30, the total transaction price to the customer must bear a reasonable relationship to the prevailing market price of the security. In a principal transaction, the dealer's compensation must be computed from the inter-dealer market price prevailing at the time of the customer transaction. MSRB Rule G-15 requires dealers to disclose on the customer's confirmation the commission received by the dealer when it acts as agent for the customer.

In September 2015, the MSRB sought comment on proposed amendments to require dealers to disclose the mark-up or mark-down on retail customer confirmations for specified principal transactions. Under the proposal, dealers generally would be required to disclose mark-ups or mark-downs on retail customer confirmations when they transact on the same side of the market as the customer in the customer's municipal security in one or more transactions that, in the aggregate, meet or exceed the size of the customer's transaction. FINRA also published a similar, but not identical, confirmation disclosure proposal. For more information on the FINRA and the MSRB proposals, see our Client Alerts available here and here. In response to the disclosure proposals, commenters strongly urged the MSRB and FINRA to take a coordinated and consistent approach to confirmation disclosure. The guidance proposed by the MSRB is designed to harmonize the manner in which the "prevailing market price" for municipal securities is determined with the manner established by FINRA for purposes of other types of fixed income securities.

FINRA Guidance

Adopted in 2007, supplementary material to FINRA Rule 2121 presumptively establishes the prevailing market price by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained. This presumption may be overcome in limited circumstances. If the presumption is overcome, or inapplicable, various factors are either required or permitted to be considered, in successive order, to determine the prevailing market price. Generally, a subsequent factor or series of factors may be considered only if previous factors in the hierarchy are inapplicable.

MSRB Guidance

The MSRB's proposal is generally consistent with FINRA's approach but takes into consideration factors unique to the municipal securities market and includes explanatory material that makes explicit the expectation that certain factors may frequently not be available for municipal securities.

Prevailing Market Price

Consistent with FINRA guidance, the MSRB proposed guidance would provide that the prevailing market price of a municipal security is presumptively established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with MSRB Rule G-18 on best execution. A transaction is contemporaneous under the guidance if it occurs close enough in time that it would reasonably be expected to reflect the current market price for the subject security. A dealer may overcome the presumption, in instances where: (i) interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in the municipal securities pricing; (ii) the credit quality of the municipal security changed significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the municipal security after the dealer's contemporaneous transaction.

Pricing Factors

Consistent with FINRA guidance, if a dealer can overcome the contemporaneous cost presumption, the dealer must consider, in the order listed, the following pricing information:

(i) prices of any contemporaneous inter-dealer transactions in the municipal security;

(ii) prices of contemporaneous dealer purchases or sales in the municipal security from or to institutional accounts with which any dealer regularly effects transactions in the same municipal security; or

(iii) if an actively traded municipal security, contemporaneous bid or offer quotations for the municipal security made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

The relative weight of pricing information in each category is primarily a facts and circumstances inquiry.

Similar Securities

The MSRB guidance includes explanatory material that makes explicit the expectation that the above mentioned factors may frequently not be available for municipal securities. The dealer may consider the prices and yields from contemporaneous transactions in "similar municipal securities" and yields from contemporaneous quotes for similar municipal securities.

Under the MSRB guidance, in order to determine whether a municipal security is similar, a dealer should consider: (i) credit quality considerations; (ii) the extent to which the spread at which the similar municipal security trades is comparable to the spread at which the subject municipal security trades; (iii) general structural characteristics and provisions of the issue; (iv) technical factors; and (v) the tax treatment of the similar municipal security. This approach is generally consistent with FINRA's guidance for other fixed income securities.

Economic Models

FINRA and the MSRB guidance provide that if the prevailing market price of a security cannot be obtained by applying any of the above factors, dealers may consider the prices or yields derived from economic models as a factor in assessing the prevailing market price of a security. Such economic models may take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value, and may consider all applicable pricing terms and conventions used.

Isolated Transactions and Quotations

FINRA and the MSRB guidance also provide that isolated transactions or isolated quotations generally will have little or no relevance in establishing the prevailing market price. The MSRB proposed guidance takes in to account that isolated transactions and isolated quotations may be more prevalent in the municipal securities market than other fixed income markets. As a result, the MSRB guidance indicates that dealers may give due regard to whether the relevant pricing information is being derived from an isolated transaction or quotation.

Submitting Comments

You may submit comments to the MSRB by submitting a hard copy or by submitting comments electronically here through March 31, 2016.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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