Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

SEC Seeks Comments on MSRB Rule Changes Requiring Bond Mark-ups/Mark-downs on Trade Confirmations and Guidance on "Prevailing Market Price"

The Securities and Exchange Commission (the *"SEC"*) is seeking comments on proposed Municipal Securities Rulemaking Board (*"MSRB"*) rule changes that would require dealers to disclose bond mark-ups and mark-downs on retail customer trade confirmations. Specifically, if a dealer engages in a principal trade with a non-institutional customer in a municipal security (other than a municipal fund security) and the dealer also executes one or more offsetting principal transactions on the same day that meet or exceed the size of the customer trade, the dealer would be required to disclose the dealer's mark-up or mark-down from the "prevailing market price" for the security on the customer confirmation. The rule changes also revise the supplementary material to Rule G-30 to provide guidance on establishing the "prevailing market price" and calculating mark-ups and mark-downs for municipal security principal transactions. The guidance is consistent with comparable FINRA guidance for non-municipal securities. The SEC's request for comment and notice of the proposal is available here. A similar proposal by the Financial Industry Regulatory Authority, Inc. (*"FINRA"*) related to corporate and agency debt securities was recently filed with the SEC, and our Client Alert regarding that proposal is available here. As originally anticipated, the FINRA and MSRB proposals are substantially similar in their requirements.

Previous FINRA and MSRB Proposals

In late 2014, FINRA and the MSRB proposed to amend existing rules regarding customer trade confirmations to require disclosure of various pricing information to customers for certain "retail-sized" transactions in debt securities, but the pricing disclosure would not literally have included a dealer's mark-up/mark-down on the specific customer trade. Both proposals would have required dealers to provide additional reference trade price information on customer trade confirmations when the dealer executes any retail-sized transaction with a customer and also executes a transaction as principal with one or multiple parties for the same security within the same trading day. Under both proposals, a "retail-size" transaction would have meant a purchase or sale transaction with a customer of 100 bonds or less or bonds with a par/face amount of $100,000 or less. For more information regarding the initial FINRA and MSRB proposals, please see our November 2014 Client Alert available here.

In late 2015, FINRA and the MSRB both released revisions to their initial rule proposals. Among other things, the revised proposals replaced the size-based disclosure threshold with a retail customer standard, would permit firms to use alternate methodologies for calculating the "reference price" for more complex trade scenarios, would require firms to add a link to the Trade Reporting And Compliance Engine ("*TRACE*") on the confirmation and provided additional exceptions from the requirements. The primary difference between the revised proposals was that the MSRB proposal specifically required disclosure of mark-ups and mark-downs while the FINRA pricing information disclosure would have required "reference price" disclosure that would not specifically be disclosure of a firm's mark-up or mark-down on the customer trade. For more information on the revised 2015 FINRA proposal, please see our October 2015 Client Alert available here, and for more information on the revised 2015 MSRB proposal, please see our September 2015 Client Alert available here.

Rule G-15—Confirmation Disclosure of Mark-up/Mark-down

The SEC is seeking comments on revisions to MSRB Rule G-15 (Confirmation, Clearance Settlement and Other Uniform Practice Requirements with Respect to Transactions with Customers) and Rule G-30 (Prices and Commissions). Revised Rule G-15 would require dealers to disclose their specific mark-up or mark-down from the "prevailing market price" for a municipal security (other than a municipal fund security) in certain transactions with retail customers. The mark-up or mark-down would be calculated in compliance with revised Rule G-30 and would be expressed both as a total

dollar amount and as a percentage of the prevailing market price. In addition, the proposed Rule G-15 would also require the dealer to disclose the time of execution and provide a reference and hyperlink to the Security Details page for a customer's security on the MSRB's Electronic Municipal Market Access (*"EMMA"*) website, along with a brief description of the type of information available on that page. For additional information on recent developments regarding mark-ups and mark-downs under existing FINRA and MSRB rules, see our Client Alerts here and here.

When Would Firms Need to Disclose Mark-ups/Mark-downs?

Revised Rule G-15 would require mark-up/mark-down disclosure when a dealer effects a transaction in a municipal security with a non-institutional customer on a principal basis. The disclosure would only be required if the dealer also purchased/sold the same security in one or more transactions on the same trading day in an aggregate size that equals or exceeds the size of the customer trade. For example, if a firm bought 100 bonds from various sources on a particular day and sold 100 of the same bonds to a retail customer that day, the firm would need to include mark-up disclosure on the retail customer trade confirmation. However, if the firm bought those 100 bonds on one day and sold the bonds to a retail customer the next day without any other transactions in those bonds on that day, the retail customer trade confirmation would not include any mark-up disclosure.

Retail Customers Only

The disclosure requirement is designed to apply to retail customers only. Specifically, the requirement would apply to transactions with a "non-institutional customer". Under the proposed amendments, a "non-institutional customer" means a customer with an account that is not an "institutional account" under MSRB Rule G-8(a)(xi). MSRB rules define "institutional account" to mean an account of (i) a bank, savings and loan association, insurance company or registered investment company; (ii) an investment adviser registered either with the SEC under the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (iii) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. Note that MSRB rules define the term "customer" to exclude a broker, dealer or municipal securities dealer. Accordingly, the revised rule disclosure does not apply to inter-dealer trade confirmations.

Look-Through for Non-Arms-Length Affiliate Transactions

With respect to the offsetting principal trades, where a dealer buys from, or sells to, certain affiliates, the revised rule would require the dealer to "look through" the dealer's transaction with the affiliate to the affiliate's transaction with a third party in determining when the security was acquired and whether the "same trading day" requirement has been triggered. Specifically, the rule requires dealers to apply the "look through" where a dealer's transaction with its affiliate was not at arms-length. For this purpose, an "arms-length transaction" would be considered a transaction that was conducted through a competitive process in which non-affiliate dealers could also participate (*e.g.*, pricing sought from multiple firms, or the posting of multiple bids and offers) and where the affiliate relationship did not influence the price paid or proceeds received by the dealer.

Exceptions for Functionally Separate Trading Desks and List Offering Price Transactions

The proposed rule also contains several exceptions to the proposed disclosure requirement. First, if the offsetting same day firm principal trade was executed by a trading desk that is functionally separate from the firm's trading desk that executed the transaction with the customer, the principal trade by that separate trading desk would not trigger the disclosure requirement. Firms must have policies and procedures reasonably designed to ensure that the functionally separate principal trading desk through which the dealer purchase or dealer sale was executed had no knowledge of the customer transaction. For example, the exception would allow an institutional desk within a firm to service an institutional customer without necessarily triggering the disclosure requirement for an unrelated trade performed by a separate retail desk within the firm.

Second, the proposed rule would not apply if the dealer acquired the security in a list offering price transaction and sold the security to non-institutional customers at the same list offering price on the day the securities were acquired. In a list offering price transaction, the compensation paid to the firm, such as the underwriting fee, is paid for by the issuer and described in the official statement.

Rule G-30—Prevailing Market Price

The MSRB is proposing to revise the supplementary material to Rule G-30 to provide guidance on establishing the "prevailing market price" and calculating mark-ups and

mark-downs for municipal security principal transactions. The guidance is consistent with comparable FINRA guidance for non-municipal securities under FINRA Rule 2121.02. Rule G-30(a) prohibits a dealer from engaging in a principal transaction with customers except at an aggregate price (including any mark-up or mark-down) that is fair and reasonable. The Supplementary Material to Rule G-30, among other things, provides that as part of the aggregate price to the customer, the mark-up or mark-down also must be a fair and reasonable amount, taking into account all relevant factors. In order to determine the mark-up or mark-down for a transaction to comply with Rule G-30 and the disclosure obligations in revised Rule G-15, a dealer must first identify the "prevailing market price" of the security.

The general Rule G-30 standard is that the prevailing market price of a security is generally the inter-dealer price for the security—the price at which dealers trade with each other. Under the proposed Supplementary Material to Rule G-30, there is a rebuttable presumption that the prevailing market price of a security is the dealer's contemporaneous cost or proceeds. A dealer's cost or proceeds are considered contemporaneous if the transaction occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the municipal security. A dealer may be able to demonstrate that its contemporaneous cost or proceeds are not indicative of the prevailing market price in instances where (i) interest rates changed to a degree that such change would reasonably cause a change in municipal securities pricing; (ii) the credit quality of the municipal security changed significantly; 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.

If the dealer establishes that the dealer's cost is or proceeds are not contemporaneous or if the dealer overcomes the presumption that its contemporaneous costs or proceeds are not reflective of the prevailing market price, the dealer generally must consider the following pricing factors in the order listed:

1. prices of any contemporaneous inter-dealer transactions in the municipal security;

2. 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

3. if an actively traded 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.

If these factors are not available, the proposed Supplementary Material provides a variety of non-exclusive factors related to "similar" municipal securities. The non-exclusive factors specifically listed are:

- prices, or yields calculated from prices, of contemporaneous inter-dealer transactions in a specifically defined "similar" municipal security;

- prices, or yields calculated from prices, of contemporaneous dealer purchase or sale transactions in a "similar" municipal security with institutional accounts with which any dealer regularly effects transactions in the "similar" municipal security with respect to customer mark-ups or mark-downs; and

- yields calculated from validated contemporaneous inter-dealer bid or offer quotations in "similar" municipal securities for customer mark-ups or mark-downs.

The proposed guidance provides that a "similar" municipal security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment to the investor. At a minimum, the municipal security or securities should be sufficiently similar that a market yield for the subject security can be fairly estimated from yields of the similar security or securities. The proposed guidance also sets forth a variety of non-exclusive factors that may be used in determining the degree to which a security is similar, including: (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 security trades; (iii) general structural characteristics and provisions of the issue; (iv) technical factors such as the size of the issue, the float and recent turnover of the issue, and legal restrictions on transferability as compared with the subject security; and (v) the extent to which the federal and/or state tax treatment of the "similar" municipal security is comparable to such tax treatment of the subject security.

What's Next?

You can submit comments to the SEC by submitting a hard copy, by using the SEC's internet comment form available under SR-MSRB-2016-12 at this link or by sending an email to

rule-comments@sec.gov with File Number SR-MSRB-2016-12 in the subject line. Comments must be received within 21 days from the date of publication of the filing in the Federal Register. The effective date will be no later than one year following the approval by the SEC.

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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