

Client Alert

Current Issues Relevant to Our Clients

September 28, 2015

MSRB Proposes Trade Confirmation Disclosure of Bond Mark-ups

The Municipal Securities Rulemaking Board (“MSRB”) recently proposed amendments to MSRB Rule G-15 that would require brokers, dealers and municipal securities dealers to disclose the mark-up or mark-down on retail customer confirmations for specified principal transactions. The proposed amendments replace an earlier proposal to require dealers to provide pricing reference information on retail customer confirmations. The MSRB Regulatory Notice seeking comment is available [here](#).

Prior MSRB and FINRA Proposals

MSRB Rule G-15 currently requires that a dealer disclose transaction-based remuneration on customer confirmations when the dealer acts as agent in the transaction in municipal securities. No disclosure requirement currently exists when a dealer acts as principal in such a transaction. As a result, no current Securities and Exchange Commission (“SEC”), Financial Industry Regulatory Authority, Inc. (“FINRA”) or MSRB rule requires that a dealer disclose bond mark-ups or mark-downs to customers in dealer principal transactions (which represent the vast majority of bond transactions).

In response to a 2012 SEC report on the municipal securities market, in late 2014 FINRA and the MSRB proposed to amend existing rules regarding customer trade confirmations to provide disclosure of recent trade prices directly to customers for certain “retail-sized” transactions. 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. Under FINRA and MSRB rules, the term “customer” does not include another broker-dealer. Accordingly, the prior proposals would not have applied to inter-dealer trade confirmations but would have applied to transactions with an institutional investor in an amount less than or equal to 100 bonds or \$100,000 par/face amount. The prior proposals would have required dealers to disclose on a customer confirmation the price to the dealer in a “reference transaction” and the differential between the price to the dealer and the price to the customer. Thus, the prior proposals would not have required disclosure of the specific dealer mark-up or mark-down on a customer trade. For additional information about the prior proposals, please see our Client Alert available [here](#).

In response to the 2014 proposal, several commenters expressed the view that mark-up/mark-down disclosure on riskless principal transactions could achieve similar or greater benefits than the pricing reference proposal but at significantly lower cost with equal or greater pricing transparency. As a result, the MSRB is seeking comments on proposed amendments to MSRB Rule G-15 which would incorporate a mark-up/mark-down disclosure requirement instead of a pricing reference information disclosure requirement.

Similarly, in July 2015, FINRA’s Board of Governors authorized FINRA to issue a regulatory notice regarding a revised proposal to require firms to disclose pricing information on customer confirmations for trades in corporate and agency securities with non-institutional customers, where the firm’s principal trade and the customer trade both occur on the same trading day. However, FINRA has not yet issued a regulatory notice for this proposal.

What Would Dealers Need to Disclose?

The proposed amendments to MSRB Rule G-15 would require dealers to disclose the mark-ups or mark-downs on retail customer confirmations for specified principal transactions. The draft amendments would require disclosure of:

- the mark-up or mark-down for principal transactions when the dealer transacts in a municipal security in a specified trade size on the same side of the market as the customer within two hours of the customer’s transaction; and
- a hyperlink and URL address to the Security Details page for the customer’s security on the MSRB’s Electronic Municipal Market Access system and a

brief description of the type of information available on that page.

The amendments would also require the time of trade execution, accurate to the nearest minute, on all customer confirmations.

Under the proposal, the mark-up or mark-down to be disclosed on the customer confirmation would be the difference between the price to the customer and the prevailing market price for the security. For purposes of calculating the mark-up or mark-down, the MSRB presumes that the prevailing market price for the customer's security would be established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with applicable MSRB rules. The disclosed mark-up or mark-down would be required to be expressed both as a total dollar amount and as a percentage of the principal amount of the customer transaction.

What Trades Would the Disclosure Cover?

The proposed disclosure would not apply to all dealer principal transactions. Under the draft amendments, dealers generally would be required to disclose the mark-up or mark-down on a retail customer confirmation only for principal transactions where:

- the dealer transacts on the same side of the market as the customer in the same security in one or more transactions that, in the aggregate, meet or exceed the size of the customer transaction; and
- the dealer's transaction occurs within the two hours preceding or following the customer transaction.

For example, the disclosure requirement would apply if a dealer sold 50 bonds to a customer (customer is buying bonds) and the dealer also bought 50 or more of the same bond within two hours before or two hours after its customer trade. If the dealer bought the bonds outside of that four-hour window or bought less than 50 bonds within that window, the disclosure requirement would not apply. Note that this does not technically limit the disclosure to "riskless principal" transactions but the MSRB believes that this timeframe is sufficient to cover transactions that would generally be considered "riskless principal" trades.

Disclosure of the mark-up or mark-down would be required for transactions for accounts other than "institutional accounts." MSRB rules define "institutional account" to include the account of (1) a bank, savings and loan association, insurance company, or registered investment company; (2) a state or federally registered

investment adviser; or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million. As a result, the disclosure requirement would apply to all retail customer accounts.

The draft amendments would also exclude transactions in new issue securities effected at the list offering price by members of the underwriting group (i.e., a transaction that is a "list offering price transaction" as defined in MSRB rules).

How Do Dealers Disclose Transactions with Affiliated Dealers?

Dealers that, on an exclusive basis, acquire municipal securities from, or sell municipal securities to, an affiliate that holds inventory in such securities and transacts with other market participants, would be required to "look through" the transaction with the affiliated dealer. The "look through" would require the dealer to substitute the affiliate's trade with the third party from whom it purchased or to whom it sold the security to determine whether disclosure of the mark-up or mark-down would be required. This issue should logically arise only where a dealer holding inventory for another dealer directly or indirectly controls, is controlled by, or is under common control with the other dealer.

Functionally Separate Trading Desks

A dealer with multiple principal trading desks would ordinarily look across all of its trading desks to determine whether a mark-up disclosure is required. However, for dealers whose trading desks operate independently of one another such that one trading desk may have no knowledge of the transactions executed by another trading desk within the same dealer. Under such structures, mark-up disclosure would not be required for a customer transaction if the dealer can establish that:

- the principal trading desk that executed the customer transaction is functionally separate from the principal trading desk that executed the dealer's same-side of the market transaction; and
- the principal trading desk executing the same-side transaction had no knowledge of the retail customer transaction.

The MSRB noted that a dealer may establish that trading desks are functionally separate through the firm's policies and procedures.

Providing Comments

You may submit comments on the proposed MSRB rule changes on or before November 20, 2015. Comments on the MSRB proposal may be submitted by hard copy or through MSRB's internet comment form available [here](#).

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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