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Fair Practice

Affected Rules
[Rule G-47](#)

Interpretive Notice Regarding Rule G-47, on Time of Trade Disclosure Disclosure of Market Discount

Overview

MSRB Rule G-47, on time of trade disclosure, requires brokers, dealers and municipal securities dealers (collectively, “dealers”) to disclose to their customers, at or prior to the time of trade, all material information known about the transaction, as well as material information about the municipal security that is reasonably accessible to the market. The MSRB has previously provided interpretive guidance, now codified in supplementary material to Rule G-47, on specific types of information that is material where specific scenarios occur and requires time of trade disclosure. Rule G-47, however, emphasizes that this list of specific disclosures is not exhaustive, and that other information may be material to a customer and required to be disclosed. The MSRB is publishing this notice to state its interpretation that the fact that a municipal security bears market discount is material information that must be disclosed to a customer under Rule G-47.

Market Discount

When a municipal security is acquired in the secondary market for less than par value, the security may have “market discount.” The amount of market discount is equal to the excess, if any, of the stated redemption price at maturity over the basis of the security immediately after its purchase by the investor. Market discount occurs when the value of a municipal security declines after its issue date—which often may occur due to a rise in interest rates. The fact that a municipal security bears market discount may significantly affect its tax treatment. Under federal tax law, for bonds purchased after April 30, 1993, the market discount is taxed at the investor’s ordinary income tax rate, rather than the capital gains rate.¹

¹ Tax treatment and the amount of market discount and original issue discount (if any) are determined in accordance with the provisions of the Internal Revenue Code and the rules and regulations of the Internal Revenue Service.



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Original Issue Discount Bonds. Market discount is calculated differently for original issue discount (OID) bonds. An OID bond is a bond that was sold at the time of issue at a price that included an original issue discount. The original issue discount is the amount by which the bond's stated redemption price at maturity exceeded its public offering price at the time of its original issuance and, for a tax-exempt municipal security, is generally treated as tax-exempt interest.²

Market discount exists for an OID bond when the bond is acquired in the secondary market for less than its revised or adjusted issue price. The revised or adjusted issue price for an OID bond is equal to the bond's original issue price plus the accrued OID up to the date of purchase. The amount of market discount is equal to the excess, if any, of the revised issue price over the basis of the bond immediately after its purchase by the investor.

De Minimis Rule. Bonds with a *de minimis* amount of market discount are subject to more favorable tax treatment than bonds with a non-*de minimis* amount of market discount. Under the *de minimis* rule, if the amount of market discount is less than one-fourth of 1% (.0025) of the stated redemption price of the bond multiplied by the number of complete years from the date of purchase to the date of maturity, the market discount is *de minimis* and is generally taxed as a capital gain, rather than ordinary income.

Market Discount Disclosure at or Prior to Time of Trade

As noted, Rule G-47 requires dealers to disclose to their customers, at or prior to the time of trade, "all material information known about the transaction, as well as material information about the security that is reasonably accessible to the market."³ This disclosure obligation applies whether the transaction is unsolicited or recommended, and whether it is a primary offering or secondary market transaction. Information is considered to be material under Rule G-47 if there is a substantial likelihood that the

² For more information about original issue discount bonds, see MSRB, About Original Issue Discount Bonds, available at: <http://www.msrb.org/msrb1/pdfs/Original-Issue-Discount-Bonds.pdf>.

³ MSRB Rule G-47(a). However, under MSRB Rule G-48, on transactions with sophisticated municipal market professionals, a dealer is relieved of the obligation to disclose to a sophisticated municipal market professional or SMMP material information that is reasonably accessible to the market. See Rule G-48(a). Accordingly, dealers do not have an obligation to disclose to SMMPs the existence of market discount.

information would be considered important or significant by a reasonable investor in making an investment decision. The MSRB has previously stated, and codified as supplementary material to Rule G-47, that the fact that a municipal security bears an original issue discount is material information that dealers are obligated to disclose, because it may affect the tax treatment of the security.⁴ Significantly, in explaining this interpretation of the MSRB's rules, the MSRB noted that appropriate disclosure of a security's original issue discount feature should assist customers in computing the market discount or premium on their transaction. The MSRB also noted its concern that, absent adequate disclosure of a security's original issue discount status, an investor might not be aware that all or a portion of his or her investment return represented by accretion of the discount is tax-exempt, and might therefore, for example, sell the security at an inappropriately low price (*i.e.*, a price not reflecting the tax-exempt portion of the discount).

Similarly, the MSRB is concerned that, absent adequate disclosure that a security has market discount, an investor might not be aware that all or a portion of his or her investment return represented by accretion of the market discount is taxable as ordinary income, and therefore might, for example, purchase the securities at an inappropriately high price (*i.e.*, a price not reflecting the potentially higher tax rate applicable to the discount). The existence of market discount may impact an investor's decision to purchase or sell an affected bond or determination of what price to pay or accept for such bond. As a result, the MSRB believes that the fact that a security has market discount is material information that is required to be disclosed to a customer under Rule G-47 at or prior to the time of trade.

Questions about this notice should be directed to Saliha Olgun, Assistant General Counsel, at 202-838-1500.

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⁴ See MSRB Rule G-47, Supplementary Material .03(f); see also Interpretive Reminder Notice Regarding Rule G-17, on Disclosure of Material Facts—Disclosure of Original Issue Discount Bonds (January 5, 2005); Rules G-12 and G-15, Comments Requested on Draft Amendments on Original Issue Discount Securities, *MSRB Reports*, Vol. 4, No. 6 (May 1994) at 7.