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**Affected Rules**

[Rule G-15](#)

[Rule G-30](#)

## New Disclosure Requirements Under MSRB Rule G-15 and Prevailing Market Price Guidance Pursuant to Rule G-30 Effective May 14, 2018

### Overview

On November 17, 2016, the Municipal Securities Rulemaking Board (MSRB) received approval from the Securities and Exchange Commission (SEC) for a proposed rule change to MSRB Rule G-15 on confirmation, clearance, settlement and other uniform practice requirements with respect to customer transactions, and Rule G-30, on prices and commissions, to require brokers, dealers and municipal securities dealers (collectively, “dealers”) to disclose mark-ups and mark-downs (collectively, “mark-ups” unless the context requires otherwise) to retail customers on certain principal transactions and to provide dealers guidance on prevailing market price for the purpose of determining mark-ups and other Rule G-30 determinations.<sup>1</sup> The MSRB believes requiring dealers to disclose their mark-ups on retail customer confirmations would provide meaningful and useful pricing information to retail investors and may result in lower transaction costs for such investors. The MSRB also believes that additional guidance on establishing the prevailing market price and determining mark-ups would promote consistent compliance by dealers with their existing fair-pricing obligations under MSRB rules and would support effective compliance with amendments to Rule G-15.

The new disclosure requirements and prevailing market price guidance will become effective on May 14, 2018, approximately 18 months from the date of SEC approval.

Questions about this notice may be directed to Michael L. Post, General Counsel – Regulatory Affairs; Margaret Blake, Associate General Counsel; or Saliha Olgun, Assistant General Counsel, at 202-838-1500.



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<sup>1</sup> See [Securities Exchange Act Release No. 79347 \(Nov. 17, 2016\), File No. SR-MSRB-2016-12](#).

## Background

The MSRB is charged by Congress to foster a free and open municipal securities market and to protect investors and the public interest.<sup>2</sup> Under this mandate, the MSRB has adopted a set of rule provisions that address dealer pricing and compensation, as well as transaction confirmations. Rule G-30, on prices and commissions, 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) that is fair and reasonable. For such principal transactions, the total transaction price to the customer must bear a reasonable relationship to the prevailing market price of the security, and the mark-up, as part of the aggregate price, must also be fair and reasonable.<sup>3</sup> For purposes of Rule G-30, the mark-up is calculated based on the inter-dealer market price prevailing at the time of the customer transaction.<sup>4</sup> When executing a transaction on an agency basis, the commission or service charge must not be in excess of a fair and reasonable amount.<sup>5</sup> Whether effecting a transaction on a principal or agency basis, dealers must exercise reasonable diligence in establishing the market value of the security and the reasonableness of their compensation.<sup>6</sup> Under Rule G-15, dealers are required to disclose on the customer confirmation transaction-based remuneration received from the customer when the dealer acts as agent. The amendments to Rule G-15 will establish a mark-up disclosure requirement for dealers in municipal securities when engaging in a specified class of principal transactions, and the amendments to Rule G-30 will provide dealers guidance on prevailing market price for the purpose of determining mark-ups and making other Rule G-30 determinations.

To inform its development of the amendments to Rule G-15 and Rule G-30, the MSRB sought public comment on draft amendments in three separate requests for comment. In response to the requests for comment, the MSRB received a total of 63 letters from a diverse group of commenters. The MSRB found the input from commenters to be highly informative and valuable. After carefully considering the comments received in response to each

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<sup>2</sup> *E.g.*, Securities Exchange Act of 1934 Section 15B(b)(2)(C), 15 U.S.C. 78o-4(b)(2)(C).

<sup>3</sup> See Rule G-30, Supplementary Material .01(c) and (d).

<sup>4</sup> See Rule G-30, Supplementary Material .01(d).

<sup>5</sup> See Rule G-30(b)(ii).

<sup>6</sup> See Rule G-30, Supplementary Material .01(a).

request, the MSRB made significant revisions to the draft amendments before filing the proposed amendments with the SEC. After filing the proposed amendments, the MSRB carefully considered all comments submitted to the SEC, as reflected in revisions to the original filing that were responsive to or derivative of comments received. The MSRB believes that the development of the amendments was greatly enhanced by the active participation of commenters and is appreciative of commenter engagement in the development of the new requirements and guidance.

## Summary of the New Requirements and Guidance

### Mark-up Disclosure Requirements Under Rule G-15

The new mark-up disclosure requirements under Rule G-15 will require a dealer to disclose its mark-up (or mark-down) on a transaction where the dealer buys (or sells) a municipal security on a principal basis from (or to) a non-institutional customer and engages in one or more offsetting principal trade(s) on the same trading day in the same security, where the size of the dealer's offsetting principal trade(s), in the aggregate, equals or exceeds the size of the customer trade. A non-institutional customer is a customer with an account that is not an institutional account, as defined in Rule G-8(a)(xi), (*i.e.*, a retail customer account).<sup>7</sup>

### *Non-Arms-Length Affiliate Transactions*

With respect to the offsetting principal trade(s), where a dealer buys from, or sells to, an affiliate in a transaction that is not at arms length, the dealer will be required to “look through” its transaction with the affiliate to the affiliate's transaction(s) with third parties in determining when the security was acquired or liquidated and whether the “same trading day” requirement has been triggered.<sup>8</sup> An “arms-length transaction” is a transaction that was conducted through a competitive process in which non-affiliate dealers could also participate—*e.g.*, pricing sought from multiple dealers, or the posting of

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<sup>7</sup> Rule G-8(a)(xi) defines an institutional account as

the account of (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (iii) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>8</sup> Similarly, in the case of a non-arms-length transaction with an affiliate, the dealer also is required to “look through” to the affiliate's transaction(s) with third parties in the security and the time of trade and related cost or proceeds of the affiliate in determining the mark-up pursuant to Rule G-30.

multiple bids and offers—and where the affiliate relationship did not influence the price paid or proceeds received by the dealer. As a general matter, the MSRB expects that the competitive process used in an “arms-length” transaction, *e.g.*, the request for pricing or platform for posting bids and offers, is one in which non-affiliates have frequently participated.

*Exceptions for Functionally Separate Trading Desks, List Offering Price Transactions and Municipal Fund Securities*

Functionally Separate Trading Desks. The new mark-up disclosure requirements contain limited exceptions. First, if the offsetting same-day dealer principal trade is executed by a trading desk that is functionally separate from the dealer’s trading desk that executed the transaction with the customer, the principal trade by that separate trading desk will not trigger the disclosure requirement. Dealers must have in place 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. The exception will allow an institutional desk within a dealer to service an institutional customer without triggering the disclosure requirement for an unrelated trade performed by a separate retail desk within the dealer.

List Offering Price Transactions. Second, a dealer will not be required to disclose the mark-up if the customer transaction is a list offering price transaction, as defined in paragraph (d)(vii)(A) of MSRB Rule G-14 RTRS Procedures. Specifically, a “list offering price transaction” is a primary market sale transaction executed on the first day of trading of a new issue by a sole underwriter, syndicate manager, syndicate member, selling group member, or distribution participant to a customer at the published list offering price for the security. This exception recognizes the fact that compensation disclosure may not be warranted on confirmations for these primary market transactions since for such transactions, bonds are sold at the same published list offering price to all investors, and the compensation paid to the dealer is paid for by the issuer and typically described in the official statement.

Municipal Fund Securities. Lastly, disclosure of mark-ups will not be required for transactions in municipal fund securities. Because dealer compensation for municipal fund securities transactions is typically not in the form of a mark-up, mark-up disclosure does not have application for transactions in municipal fund securities.

*Information to be Disclosed on the Customer Confirmation*

If the transaction meets the criteria described above, the dealer will be required to disclose on the customer confirmation the dealer's mark-up from the prevailing market price for the security. The mark-up must be determined in compliance with Rule G-30 and the supplementary material thereunder, including new Supplementary Material .06 (discussed below), and expressed as a total dollar amount and as a percentage of the prevailing market price of the municipal security.<sup>9</sup> Currently, under Rule G-30, dealers are required to exercise reasonable diligence in establishing the prevailing market price.<sup>10</sup> The MSRB, therefore, expects that dealers will have reasonable policies and procedures in place to establish the prevailing market price in compliance with Supplementary Material .06 and that such policies and procedures will be applied consistently across customers.

*Timing of the Mark-up Determination*

A dealer may determine, as a final matter for disclosure purposes, the prevailing market price—and therefore, the markup—based on the information the dealer has, through the use of reasonable diligence as required by Rule G-30, at the time the dealer systematically inputs the mark-up related information into its systems for the generation of the mark-up disclosure. Such timing of the determination of prevailing market price would avoid potentially open-ended delays and would also permit dealers who, on a voluntary basis, choose to disclose mark-ups on all principal transactions to generate customer confirmations at the time of trade, should they choose to do so.

Time of Execution and Link to EMMA Disclosure on All Retail Customer Confirmations

The amendments to Rule G-15 will also require dealers to disclose, in a format specified by the MSRB, a reference and, if the confirmation is electronic, a hyperlink to a webpage on the MSRB's Electronic Municipal Market Access (EMMA<sup>®</sup>) website that contains publicly available trading data for the specific security that was traded. Thus, all printed confirmations for which the disclosure will be required must include the uniform resource

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<sup>9</sup> Although labeling the disclosure "approximate" or "estimated" would not be consistent with the disclosure requirement in Rule G-15, dealers may include on the customer confirmation explanatory language or disclosures to provide context and understanding for investors receiving mark-up disclosures, such as an explanation of how the disclosure was derived. As long as such explanatory language is accurate and not misleading, the MSRB believes that dealers should have the flexibility to determine how to craft such language for their customers.

<sup>10</sup> See Rule G-30, Supplementary Material .04(b).

locator (URL) to the applicable webpage, and all electronic confirmations for which the disclosure will be required must include a hyperlinked URL to the applicable webpage. This disclosure requirement will be limited to transactions with retail (*i.e.*, non-institutional) customers, but will apply for all such transactions regardless of whether a mark-up disclosure is required for the transaction. Under the new disclosure requirements, the dealer also must disclose the time of execution on all non-institutional customer confirmations, other than those for transactions in municipal fund securities.

#### Prevailing Market Price Guidance

The amendments to Rule G-30 add new supplementary material (paragraph .06 entitled “Mark-Up Policy”) and amend existing supplementary material to provide guidance on establishing the prevailing market price and determining mark-ups and mark-downs for principal transactions in municipal securities.

Revisions to Supplementary Material .01(a) will clarify that a dealer must exercise “reasonable” diligence in establishing the market value of a security and the reasonableness of the compensation received. This requirement is consistent with existing Supplementary Material .04(b) (“[D]ealers must establish market value as accurately as possible using reasonable diligence under the facts and circumstances”) and will clarify that the same standard applies under the Supplementary Material .01(a). The amendments to Supplementary Material .01(d) will clarify the relationship between that provision and the new Supplementary Material .06 containing the prevailing market price guidance.

Under new Supplementary Material .06, the prevailing market price of a municipal security generally will be presumptively established 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 if it is not applicable because the dealer’s cost is (or proceeds are) not contemporaneous, various factors discussed below 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, or “waterfall,” are inapplicable.

Below is a summary of several significant aspects of the prevailing market price guidance.

#### *Rebuttable Presumption Based on Contemporaneous Cost or Proceeds*

The prevailing market price guidance builds on the standard in existing supplementary material to Rule G-30 that the prevailing market price of a security is generally the price at which dealers trade with one another (*i.e.*,

the inter-dealer price).<sup>11</sup> The guidance provides that the best measure of prevailing market price is presumptively established by referring to the dealer's contemporaneous cost (proceeds), as consistent with other MSRB pricing rules, such as the best-execution rule (Rule G-18). Under the prevailing market price guidance, a dealer's cost or proceeds will be 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. The reference to dealer contemporaneous cost or proceeds in determining the prevailing market price reflects a recognition of the principle that the prices paid or received for a security by a dealer in actual transactions closely related in time are normally a highly reliable indication of the prevailing market price and that the burden is appropriately on the dealer to establish the contrary.

When selling a municipal security to a customer, a dealer may look to other evidence of the prevailing market price (other than contemporaneous cost) only where the dealer, when selling the security, made no contemporaneous purchases in the municipal security or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price. When buying a municipal security from a customer, the dealer may look to other evidence of the prevailing market price (other than contemporaneous proceeds) only where the dealer made no contemporaneous sales in the municipal security or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

A dealer may be able to show that its contemporaneous cost (when it is making a sale to a customer) or proceeds (when it is making a purchase from a customer) are not indicative of the prevailing market price, and thus overcome the presumption, 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.

#### *Hierarchy of Pricing Factors*

Under the prevailing market price guidance, if the dealer has established that the dealer's cost is (or proceeds are) not contemporaneous or if the dealer

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<sup>11</sup> See Rule G-30, Supplementary Material .01(d) ("Dealer compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction.").



has overcome the presumption that its contemporaneous cost or amount of proceeds provides the best measure of the prevailing market price, the dealer will be required to consider, in the order listed (subject to Supplementary Material .06(a)(viii), on isolated transactions and quotations), a hierarchy of three additional types of pricing information, referred to here as the hierarchy of pricing factors: (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 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.

Pricing information of a succeeding type in this hierarchy may only be considered where the prior type does not generate relevant pricing information. In reviewing the available pricing information of each type, the relative weight of the information, for purposes of identifying prevailing market price, depends on the facts and circumstances of the comparison transaction or quotation. The prevailing market price guidance also makes clear the expectation that, because of the lack of active trading in many municipal securities, these factors may frequently not be available in the municipal market. Accordingly, dealers may often need to consult factors further down the waterfall, such as “similar” securities and economic models, to identify sufficient relevant and probative pricing information to establish the prevailing market price of a municipal security.

#### *Similar Securities*

If the above factors are not available, the prevailing market price guidance provides that a dealer may take into consideration a non-exclusive list of factors that are generally analogous to those set forth under the hierarchy of pricing factors, but applied here to prices and yields of specifically defined “similar” securities. However, unlike the factors set forth in the hierarchy of pricing factors, which must be considered in the specified order, the factors related to similar securities are not required to be considered in a particular order or particular combination. 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 (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 (mark-downs); and

- Yields calculated from validated contemporaneous inter-dealer bid (offer) quotations in “similar” municipal securities for customer mark-ups (mark-downs).

When applying one or more of the factors, a dealer must consider that the ultimate evidentiary issue is whether the prevailing market price of the municipal security will be correctly identified. The relative weight of the pricing information obtained from the factors depends on the facts and circumstances surrounding the comparison transaction, such as whether the dealer in the comparison transaction was on the same side of the market as the dealer in the subject transaction, the timeliness of the information and, with respect to the final bulleted factor above, the relative spread of the quotations in the “similar” municipal security to the quotations in the subject security.

The prevailing market price 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 the yields of the “similar” security or securities. Where a municipal security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security. The guidance also sets forth a number of non-exclusive factors that may be used in determining the degree to which a security is “similar.” These include: (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.

Because of the unique characteristics of the municipal securities market, including the large number of vastly different issuers and the highly diverse nature of most outstanding securities, the MSRB expects that, in order for a security to qualify as sufficiently “similar” to the subject security, such security will be at least highly similar to the subject security with respect to nearly all of the listed “similar” security factors that are relevant to the subject security at issue. As a result, and due also in part to the lack of active trading in many municipal securities, dealers in the municipal securities

market likely may not often find pricing information from sufficiently similar securities and may frequently need to then consider economic models at the next level of the waterfall analysis.

When a security's value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to meet the specific obligations of the security (often referred to as "story bonds"), in most cases other securities would not be sufficiently similar, and therefore, other securities may not be used to establish the prevailing market price.

#### *Economic Models*

If information concerning the prevailing market price of a security cannot be obtained by applying any of the factors at the higher levels of the waterfall, dealers may consider as a factor in assessing the prevailing market price of a security the prices or yields derived from economic models. Such economic models may take into account measures such as reported trade prices, 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.

As a general matter, when a dealer seeks to identify prevailing market price using other than the dealer's contemporaneous cost or contemporaneous proceeds, the dealer must be prepared to provide evidence that would establish the dealer's basis for not using contemporaneous cost (proceeds), and information about the other values reviewed. Consistent with this approach, if a dealer relies upon figures derived from a model the dealer uses or has developed internally, the dealer must be able to provide information that was used on the day of the transaction to develop the figures. While this requirement will not apply to a dealer that uses a third-party economic model by contracting with, or outsourcing to, a third party, such dealer should have a reasonable basis for believing the third party's pricing methodologies produce evaluated prices that reflect actual prevailing market prices. Dealers are also cautioned that the ultimate responsibility to determine the market value of a security and ensure the fairness and reasonableness of a price and any related mark-up or mark-down under Rule G-30 lies with them.<sup>12</sup>

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<sup>12</sup> The supervisory system and written supervisory procedures for a dealer that uses third-party evaluated prices to assist it in determining the prevailing market price of a municipal security should be appropriately tailored to reflect this outsourced function. Among other things, the dealer must have procedures regarding the dealer's outsourcing practice that are reasonably designed to ensure compliance with applicable securities laws and regulations

### *Isolated Transactions and Quotations*

The prevailing market price guidance states that isolated transactions or isolated quotations generally have little or no weight or relevance in establishing the prevailing market price. Due to the unique nature of the municipal securities market, including the large number of issuers and outstanding securities and the infrequent trading of many securities in the secondary market, the prevailing market price guidance recognizes that isolated transactions and quotations may be more prevalent in the municipal securities market than other fixed income markets and explicitly recognizes that an off-market transaction may qualify as an “isolated transaction” under the guidance.

The prevailing market price guidance also addresses the application of the “isolated” transactions and quotations provision. The guidance explains that, for example, in considering the factors in the hierarchy of pricing factors, a dealer may give little or no weight to pricing information derived from an isolated transaction or quotation. The guidance also provides that, in considering yields of “similar” securities, except in extraordinary circumstances, dealers may not rely exclusively on isolated transactions or a limited number of transactions that are not fairly representative of the yields of transactions in “similar” municipal securities taken as a whole.

### *Contemporaneous Customer Transactions*

Because the prevailing market price guidance ultimately seeks to identify the prevailing inter-dealer market price, a dealer’s contemporaneous cost (for customer sales) or proceeds (for customer purchases) in an *inter-dealer* transaction is presumptively the prevailing market price of the security. Where the dealer has no contemporaneous cost or proceeds, as applicable, from an inter-dealer transaction, the dealer must then consider whether it has contemporaneous cost or proceeds, as applicable, from a *customer* transaction. In establishing the presumptive prevailing market price, in such instances, the dealer should refer to such contemporaneous cost or proceeds and make an adjustment for any mark-up or mark-down charged in that customer transaction. To identify the prevailing market price for the purpose

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and MSRB rules. The procedures should include, without limitation, a due diligence analysis of the third-party service provider to determine whether such party is capable of performing the outsourced services. Dealers should also ensure that an appropriately qualified person monitors the arrangement. Additionally, dealers should ensure that all applicable regulators have the same complete access to the pricing service’s work product for the dealer, as would be the case if the covered activities had been performed directly by the dealer.

of calculating the mark-up or mark-down in the contemporaneous customer transaction, the dealer should proceed down the waterfall, according to its terms, identifying the most relevant and probative evidence of the prevailing inter-dealer market price.

Thus, where a dealer lacks a contemporaneous purchase from another dealer, the prevailing market price in connection with a sale to a customer should be established by identifying any contemporaneous cost from a transaction with another customer and then making an upward adjustment. The adjustment, sometimes referred to as an “imputed markdown,” should then be added to the dealer’s purchase price from the customer to establish pricing at the level at which an inter-dealer trade might have occurred. Similarly, in determining the prevailing market price of a municipal security in connection with a purchase from a customer, where the dealer lacks a contemporaneous sale to another dealer, the prevailing market price should be established by identifying any contemporaneous proceeds in a transaction with another customer, and then making a downward adjustment by deducting an “imputed mark-up.”<sup>13</sup>

This approach is supported by the relevant case law and is consistent with the text of the guidance because the presumptive prevailing market price, through this methodology, is established “by referring to” the dealer’s contemporaneous cost or proceeds, as required by the prevailing market price guidance under Supplementary Material .06(a)(i). Moreover, this approach is consistent with the fundamental principle underlying the guidance, because it results in a reasonable proxy for what the dealer’s

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<sup>13</sup> For example, assume that Dealer A sells municipal security X to Dealer B at a price of 98.5. Then, assume that Dealer C purchases municipal security X from a customer at a price of 98 and contemporaneously sells the security to another customer at a price of 100. Because Dealer C itself has no contemporaneous inter-dealer transactions in the security, it would proceed down the waterfall to the hierarchy of pricing factors, discussed *supra*. A dealer at that level of the waterfall analysis must first consider prices of any contemporaneous inter-dealer transaction in establishing the prevailing market price. Accordingly, Dealer C would consider the contemporaneous inter-dealer transaction between Dealer A and Dealer B at 98.5 in determining the amount of the mark-down for the dealer purchase, and deduct its contemporaneous cost of 98 from 98.5 to arrive at a mark-down of 0.5. Then, Dealer C would add the amount of the mark-down to the dealer’s contemporaneous cost for a presumptive prevailing market price (or adjusted contemporaneous cost) of 98.5. In the absence of evidence to rebut the presumption, when disclosing the mark-up to the customer to whom Dealer C sold municipal security X, Dealer C would disclose the difference between Dealer C’s adjusted contemporaneous cost (98.5) and the price paid by the customer to whom Dealer C sold municipal security X (100) for a mark-up of 1.5 (1.52% of the prevailing market price).

contemporaneous cost or proceeds would have been in an inter-dealer transaction.

This interpretation of the prevailing market price guidance takes on special significance in the context of the new mark-up disclosure requirement under Rule G-15. Where, for example, a dealer purchases a security from one retail customer and contemporaneously sells it to another retail customer, with no relevant market changes in the interim, the total difference between the two prices may be attributed to dealer compensation, but each customer pays only a portion of this difference (as either a mark-up or a mark-down). Without adjustments to the contemporaneous cost and proceeds based on the mark-down and mark-up, respectively, the confirmation disclosures to both customers would reflect “double counting.” By contrast, under the adjustment approach, where there are no relevant market changes in the interim that would rebut the presumption, there is a complete apportionment of the total difference in price (*i.e.*, no double counting and no part of the total difference in price left undisclosed to a customer).

#### *Non-Arms-Length Affiliate Transactions*

Where a dealer will be required to “look through” a transaction in a security with its affiliate to the circumstances of the affiliate’s transaction(s) in the security with third parties to determine whether a mark-up disclosure obligation is triggered under Rule G-15, the dealer will also be required to “look through” to such affiliate’s contemporaneous cost or proceeds in determining the amount of the dealer’s mark-up pursuant to Rule G-30. In addition, this substantive “look through” requirement will also apply more generally under Rule G-30 for purposes of evaluating the fairness and reasonableness of mark-ups, even where mark-up disclosure will not be required under Rule G-15. Therefore, as noted in the discussion above of the mark-up disclosure requirement, a non-arms-length transaction in a security (as defined in that context) with an affiliate should not be used to identify a dealer’s contemporaneous cost or proceeds and presumptively the prevailing market price of the security.<sup>14</sup>

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<sup>14</sup> For example, assume Dealer A1, a market-facing dealer, and Dealer A2, a retail customer-facing dealer, are affiliates both owned by Company A. On the same trading day, Dealer A1 purchases municipal security X from an unaffiliated dealer at \$90 (“Transaction 1”). Dealer A1 displays municipal security X for sale at \$93 on Dealer A2’s customer-facing platform, on which other dealers have not frequently participated. A retail customer places an order to purchase municipal security X from Dealer A2 at the displayed price of \$93. Dealer A2 purchases municipal security X from Dealer A1 at \$93 in a non-arms-length transaction within the meaning of the new disclosure requirements under Rule G-15 (“Transaction 2”). Dealer A2 then sells municipal security X to the retail customer at \$93, plus \$1 trading fee (“Transaction 3”). During the day, there are no other transactions in municipal security X and

### *Compliance at the Time of Generation of Disclosure*

As noted above, a dealer may determine, as a final matter for disclosure purposes, the prevailing market price—and therefore, the mark-up—based on the information the dealer has, through the use of reasonable diligence as required by Rule G-30, at the time the dealer systematically inputs the information into its systems to generate the mark-up disclosure.

Such timing of the determination of prevailing market price would avoid potentially open-ended delays that could otherwise result if dealers were required to wait to generate a disclosure until they could, for example, determine that they do not have any “contemporaneous” proceeds for a particular transaction.<sup>15</sup> Such timing also permits dealers that, on a voluntary basis, disclose mark-ups and mark-downs in a broader class of principal transactions to generate customer confirmations at the time of trade, should they choose to do so. To clarify, a dealer will not be expected to cancel and resend a confirmation to revise the mark-up or mark-down disclosure solely based on the occurrence of a subsequent transaction or event that otherwise would be relevant to the determination of the mark-up or mark-down under the prevailing market price guidance. Where, however, a dealer, for example, has contemporaneous proceeds by the time of the inputting of the information into the dealer’s systems to generate the disclosure, the dealer (in accordance with the prevailing market price guidance) presumptively will

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no other dealers display any price for municipal security X. In this example, Transaction 2 should not be used to indicate Dealer A2’s contemporaneous cost. Instead, Dealer A2 would be required to “look through” Transaction 2, a non-arms length transaction with affiliated Dealer A1, and use Transaction 1 and the time of that trade and the related cost to Dealer A1 in determining the prevailing market price.

<sup>15</sup> Assume, for example, a dealer systematically inputs the mark-up related information into its systems intra-day (*e.g.*, at the time of trade) for the generation of confirmations. If such dealer purchases a security from a customer at 9:00 AM at a time when it has no contemporaneous proceeds, the dealer may, for disclosure purposes, proceed down the waterfall to determine the prevailing market price for that trade and thus its disclosed mark-down to the customer. For fair pricing purposes, however, if that same dealer later obtains “contemporaneous” proceeds for that security, the dealer’s prevailing market price in connection with the 9:00 AM transaction would presumptively be established by reference to the later contemporaneous proceeds.

In contrast, if a dealer systematically inputs the mark-up related information into its systems at the end of the day for the generation of confirmations, under the same trading scenario described above, the dealer must consider any subsequent contemporaneous proceeds that occurred after the time of trade but before the end of the day, for both disclosure and fair-pricing purposes.

be required to establish the prevailing market price of the municipal security by reference to such contemporaneous proceeds.<sup>16</sup>

*Reasonable Policies and Procedures; Automation*

As described above, under Rule G-30, dealers must establish market value as accurately as possible using reasonable diligence under the facts and circumstances. Consistent with this longstanding standard of reasonable diligence, the MSRB expects that dealers will have reasonable policies and procedures in place to determine the prevailing market price that are consistent with Supplementary Material .06 and that such policies and procedures are applied consistently across customers. Thus, for example, dealers should establish policies and procedures pertaining to the provisions regarding functionally separate trading desks, if applicable. Similarly, as applicable, firms should establish reasonable policies and procedures relating to, without limitation, inter-affiliate transactions, the determination of imputed mark-ups, the determination of similar securities, and the use of economic models. Additionally, it may be reasonable for a dealer that chooses largely to automate the prevailing market price determination to establish in its policies and procedures objective criteria reasonably designed to implement aspects of the guidance that are not prescribed and as to which dealers would have discretion to exercise a degree of subjectivity if the determination were not automated.

November 29, 2016

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<sup>16</sup> For example, a dealer that operates an alternative trading system or ATS may often, if not always, be in a position to identify its contemporaneous proceeds in connection with a purchase from a customer. Importantly, under Rule G-18, Supplementary Material .03, a dealer must make every effort to execute a customer transaction promptly, taking into account prevailing market conditions. Any intentional delay of a transaction to avoid recognizing proceeds as contemporaneous at the time of a transaction or otherwise would be contrary to these duties to customers. A dealer found to purposefully delay the execution of a customer order for such purposes also may be in violation of Rule G-17, on conduct of municipal securities and municipal advisory activities.



## Text of Amendments\*

### Rule G-15: Confirmation, Clearance, Settlement and Other Uniform Practice Requirements with Respect to Transactions with Customers

#### (a) *Customer Confirmations.*

(i) At or before the completion of a transaction in municipal securities with or for the account of a customer, each broker, dealer or municipal securities dealer shall give or send to the customer a written confirmation that complies with the requirements of this paragraph (i):

(A) Transaction information. The confirmation shall include information regarding the terms of the transaction as set forth in this subparagraph (A):

(1) No change.

(2) Trade date and time of execution.

(a) The trade date shall be shown.

(b) The time of execution shall be shown; provided that, for a transaction for an institutional account as defined in Rule G-8(a)(xi) or a transaction in municipal fund securities, a statement that the time of execution will be furnished upon written request of the customer may be shown in satisfaction of the obligation to disclose the time of execution on the confirmation. In addition, either (a) the time of execution, or (b) a statement that the time of execution will be furnished upon written request of the customer shall be shown.

(3) – (8) No change.

(B) – (C) No change.

(D) Disclosure statements:

(1) – (3) No change.

(4) The confirmation for a transaction (other than a transaction in municipal fund securities) executed for or with a non-institutional customer shall include, in a format specified by the MSRB, a reference and, if the confirmation is electronic, a hyperlink to a webpage on EMMA that contains publicly available trading data for the specific security that was traded, along with a brief description of the type of information available on that

\* Underlining indicates new language; strikethrough denotes deletions.

page.

(E) Confirmation format. All requirements must be clearly and specifically indicated on the front of the confirmation, except that the following statements may be on the reverse side of the confirmation:

(1) – (2) No change.

~~(3) The statement concerning time of execution that can be provided in satisfaction of subparagraph (A)(2) of this paragraph.~~

(F) Mark-ups and Mark-downs.

(1) General. A confirmation shall include the dealer’s mark-up or mark-down for the transaction, to be calculated in compliance with Rule G-30, Supplementary Material .06 and expressed as a total dollar amount and as a percentage of the prevailing market price if:

(a) the broker, dealer or municipal securities dealer (“dealer”) is effecting a transaction in a principal capacity with a non-institutional customer, and

(b) the broker, dealer or municipal securities dealer purchased (sold) the security in one or more offsetting transactions in an aggregate trading size meeting or exceeding the size of such sale to (purchase from) the non-institutional customer on the same trading day as the non-institutional customer transaction. If any such transaction occurs with an affiliate of the dealer and is not an arms-length transaction, the dealer is required to “look through” to the time and terms of the affiliate’s transaction(s) with third parties in the security in determining whether the conditions of this paragraph have been met.

(2) Exceptions. A dealer shall not be required to include the disclosure specified in paragraph (F)(1) above if:

(a) the non-institutional customer transaction was executed by a principal trading desk that is functionally separate from the principal trading desk within the same dealer that executed the dealer purchase (in the case of a sale to a customer) or dealer sale (in the case of a purchase from a customer) of the security, and the dealer had in place 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;

(b) the customer transaction is a “list offering price transaction” as defined in paragraph (d)(vii) of Rule G-14 RTRS Procedures; or

(c) the customer transaction is for the purchase or sale of municipal fund securities.

(ii) – (v) No change.

(vi) Definitions. For purposes of this rule, the following terms shall have the following meanings:

(A) – (H) No change.

(I) The term “arms-length transaction” shall mean a transaction that was conducted through a competitive process in which non-affiliate firms could also participate, and where the affiliate relationship did not influence the price paid or proceeds received by the dealer.

(J) The term “non-institutional customer” shall mean a customer with an account that is not an institutional account, as defined in Rule G-8(a)(xi).

(vii) – (viii) No change.

(b) – (g) No change.

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### **Rule G-30: Prices and Commissions**

(a) – (b) No change.

### **Supplementary Material**

#### **.01 General Principles.**

(a) Each broker, dealer or municipal securities dealer (each, a “dealer,” and collectively, “dealers”), whether effecting a trade on an agency or principal basis, must exercise reasonable diligence in establishing the market value of the security and the reasonableness of the compensation received on the transaction.

(b) – (c) No change.

(d) Dealer compensation on a principal transaction with a customer is considered to be a mark-up or mark-down that is computed from the ~~inter-dealer market price~~ prevailing market price at the time of the customer transaction, as described in Supplementary Material .06. 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.

(e) No change.

.02 – .05 No change.

**.06 Mark-Up Policy**

(a) Prevailing Market Price

(i) A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price. Presumptively for purposes of this Supplementary Material .06, the prevailing market price for a municipal security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with applicable MSRB rules. (See, e.g., Rule G-18).

(ii) When the dealer is selling the municipal security to a customer, other evidence of the prevailing market price may be considered only where the dealer made no contemporaneous purchases of the security or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price. When the dealer is buying the municipal security from a customer, other evidence of the prevailing market price may be considered only where the dealer made no contemporaneous sales of the security or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

(iii) A dealer's cost is (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.

(iv) A dealer that effects a transaction in municipal securities with a customer and identifies the prevailing market price using a measure other than the dealer's own contemporaneous cost (or, in a mark-down, the dealer's own proceeds) must be prepared to provide evidence that is sufficient to overcome the presumption that such contemporaneous cost (or proceeds) provides the best measure of the prevailing market price. A dealer may be able to show that such contemporaneous cost is (or proceeds are) not indicative of prevailing market price, and thus overcome the presumption, in instances where: (A) interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in municipal securities pricing; (B) the credit quality of the municipal security changed significantly after the dealer's contemporaneous transaction; or (C) 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.

(v) In instances where the dealer has established that the dealer's cost is (or, in a mark-down, proceeds are) not contemporaneous, or where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or proceeds) provides the best measure of the prevailing market price, such as those instances described in

(a)(iv)(A), (B) and (C), the dealer must consider, in the order listed and subject to (a)(viii), the following types of pricing information to determine prevailing market price:

(A) Prices of any contemporaneous inter-dealer transactions in the municipal security in question;

(B) In the absence of transactions described in (A), prices of contemporaneous dealer purchases (sales) in the municipal security in question from (to) institutional accounts with which any dealer regularly effects transactions in the same municipal security; or

(C) In the absence of transactions described in (A) and (B), for actively traded municipal securities, contemporaneous bid (offer) quotations for the municipal security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

(A dealer may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information (e.g., a dealer may consider pricing information under (B) only after the dealer has determined, after applying (A), that there are no contemporaneous inter-dealer transactions in the same security). In reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information (i.e., a particular transaction price or quotation) depends on the facts and circumstances of the comparison transaction or quotation (e.g., whether the dealer in the comparison transaction was on the same side of the market as the dealer in the subject transaction and timeliness of the information). Because of the lack of active trading in most municipal securities, it is not always possible to establish the prevailing market price for a municipal security based solely on contemporaneous transaction prices or contemporaneous quotations for the security. Accordingly, dealers may often need to consider other factors, consistent with (a)(vi) and (a)(vii) below.

(vi) In the event that, in particular circumstances, the above factors are not available, other factors that may be taken into consideration (not in any required order or combination) for the purpose of establishing the price from which a customer mark-up (mark-down) may be calculated, include but are not limited to:

- Prices, or yields calculated from prices, of contemporaneous inter-dealer transactions in a “similar” municipal security, as defined below;

- Prices, or yields calculated from prices, of contemporaneous dealer purchase (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 (mark-downs); and

- Yields calculated from validated contemporaneous inter-dealer bid (offer) quotations in “similar” municipal securities for customer mark-ups (mark-downs).

The relative weight, for purposes of identifying prevailing market price, of the pricing information obtained from the factors set forth above depends on the facts and circumstances surrounding the comparison transaction (i.e., whether the dealer in the comparison transaction was on the same side of the market as the dealer in the subject transaction, timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the similar municipal security to the quotations in the subject security).

(vii) Finally, if information concerning the prevailing market price of the subject municipal security cannot be obtained by applying any of the above factors, dealers (and the regulatory agencies responsible for enforcing MSRB rules) may consider as a factor in assessing the prevailing market price of a municipal security the prices or yields derived from economic models (e.g., discounted cash flow models) that take into account measures such as reported trade prices, credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value; and consider all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods).

(viii) Because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price. For example, in considering the pricing information described in (a)(v), a dealer may give little or no weight to pricing information derived from an isolated transaction or quotation, such as an off-market transaction. In addition, in considering yields of “similar” municipal securities, except in extraordinary circumstances, dealers may not rely exclusively on isolated transactions or a limited number of transactions that are not fairly representative of the yields of transactions in “similar” municipal securities taken as a whole.

#### (b) “Similar” Municipal Securities

(i) 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 the yields of the “similar” security or securities. Where a municipal security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security.

(ii) The degree to which a municipal security is “similar,” as that term is used in this Supplementary Material .06, to the subject security may be determined by all relevant factors, including but not limited to the following:

(A) Credit quality considerations, such as whether the municipal security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security (to the extent securities of

other issuers are designated as “similar” securities, significant recent information concerning either the “similar” security’s issuer or subject security’s issuer that is not yet incorporated in credit ratings should be considered (e.g., changes to ratings outlooks));

(B) The extent to which the spread (i.e., the spread over an applicable index or U.S. Treasury securities of a similar duration) at which the “similar” municipal security trades is comparable to the spread at which the subject security trades;

(C) General structural characteristics and provisions of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the municipal security will be called, tendered or exchanged, and other embedded options, as compared with the characteristics of the subject security;

(D) 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

(E) 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.

(iii) When a municipal security's value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to meet the specific obligations of the security, in most cases other securities will not be sufficiently similar, and therefore, pricing information with respect to other securities may not be used to establish the prevailing market price.