



June 7, 2010

Ernesto Lanza  
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Municipal Securities Rulemaking Board  
1900 Duke Street  
Suite 600  
Alexandria, VA 22314

Re: MSRB Notice 2010-10: Request for Comments on Draft Interpretive Guidance on Prevailing Market Prices and Mark-Ups for Transactions in Municipal Securities

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Dear Mr. Lanza:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> appreciates this opportunity to respond to Notice 2010-10<sup>2</sup> issued by the Municipal Securities Rulemaking Board (“MSRB”) (the “Notice”) in which the MSRB requests comments on draft interpretive guidance on prevailing market prices and mark-ups for transactions in municipal securities. We understand and appreciate that the MSRB is trying to harmonize the manner in which the prevailing market prices for municipal securities are determined with the manner established by the Financial Industry Regulatory Authority (“FINRA”)<sup>3</sup> for purposes of other types of debt securities.<sup>4</sup>

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<sup>1</sup> The Association, or “SIFMA,” brings together the shared interests of more than 550 securities firms, banks and asset managers. SIFMA’s mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the markets and the industry. SIFMA works to represent its members’ interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

<sup>2</sup> MSRB Notice 2010-10 (April 21, 2010).

<sup>3</sup> All references to FINRA shall include any predecessor organizations, such as the National Association of Securities Dealers (“NASD”).

<sup>4</sup> NASD IM-2440-2 “Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities.”

SIFMA supports effective and efficient regulation of the debt markets that helps to aid market liquidity. Although we see the value in harmonizing rules across fixed income markets, due to the unique nature of the municipal securities market<sup>5</sup>, SIFMA and its members would like to express some concerns on the draft interpretive guidance. SIFMA requests that a number of areas be altered, clarified or expanded. SIFMA respectfully requests that the MSRB: (1) allow for a more flexible approach in determining prevailing market price by dismissing the concept of a rigid hierarchy in favor of an approach that recognizes pricing is based on a myriad of factors (2) permit a more flexible approach to documenting transactions; (3) expand the exemption from the guidance to include all transactions by dealers with a SMMP; (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker; and (5) provide dealers with more guidance regarding the definition of “contemporaneous cost”. As described more fully below, we believe these changes would significantly enhance the efficient pricing of debt instruments, promote liquidity in the bond markets, and provide meaningful, practical guidance that is consistent with the manner in which dealers and institutional investors make pricing determinations.

#### The Hierarchy Process Is Not Workable; Menu of Factors Should be Used Instead

Given the fast pace and high-pressure nature of most bond trading desks, it is difficult (if not impossible) to imagine a dealer actually going through the steps outlined in the proposed draft guidance. Specifically, each time a trader buys or sells a bond from a customer, the trader would need to undergo a formalistic process *before* engaging in the trade. The draft guidance requires dealers to follow a strict, defined process to determine prevailing market price in these instances (i.e., the “Hierarchy” or “Waterfall”). To a trader, this process is a rigid construct that does not reflect the way the debt markets operate or the manner in which dealers and institutional investors determine pricing:

- First, the trader must determine if there are any “contemporaneous” trades in the security.
- Next, the trader must determine whether there are any credit events, news events, or interest rate changes that might negate the presumption that contemporaneous cost is the best evidence of prevailing market price.
- Third, the trader must: (1) identify interdealer trades (if any); (2) if there are none, identify institutional trades (including determining that the customer’s trade

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<sup>5</sup> The MSRB has set forth in the draft guidance many of the unique qualities of the municipal bond market, such as the large number of outstanding bonds (represented by over 1.3 million distinct CUSIP numbers), the prevalence of “buy and hold” investors, the infrequent secondary market trading in most issues, the existence of multiple market sectors, differing rules for tax treatment, differing credit structures, credit enhancements, and call and put features.

qualifies under the rule or is excluded); (3) if there are none, determine whether the market is “active” and if so, whether there are any quotes.

- If none of these factors is available, the trader must look at: (1) prices of interdealer trades in similar securities; (2) prices of institutional customer trades in “similar securities” (as that term is defined under the draft guidance); (3) yields from interdealer trades; (4) yields from institutional customer trades (including determining that the customer’s trade qualifies under the draft guidance); and (5) yields computed from validated quotes.
- Finally, if (and only if) none of these factors is available, the dealer may look to economic models.

Also, in applying the Hierarchy, the trader would be required to consciously disregard other available information – even if the trader has a good faith belief that such information is relevant to a pricing determination.

SIFMA believes that it is inappropriate to expect that dealers will go through the process described above, while at the same time ignoring information that they may believe is important to pricing. The draft guidance would place supervisors and compliance officers in a very difficult position because it would result in their conducting after-the-fact reviews of trades, working to fit particular trades into the Hierarchy on a post hoc basis. Supervisors and compliance officers conducting after-the-fact reviews of trades may face situations where, based on all relevant pricing factors, the firm’s pricing seems appropriate, although a strict application of the Hierarchy may suggest a different result. A pricing Hierarchy is inappropriate in a market where electronic reference points are not easily obtained and liquidity is not always stable across the market.

SIFMA is concerned that a Hierarchy may lead to inaccurate determinations of prevailing market price because it requires dealers to ignore important pricing information. A strict application of the Hierarchy also would be difficult for dealers to apply in practice because it does not fully reflect the way that dealers and institutional investors make pricing determinations. The rigidity of the Hierarchy would require dealers consciously to ignore information that is relevant to their pricing decisions in determining prevailing market price where dealers establish that contemporaneous cost is not the best evidence of prevailing market price or that prior trades are not contemporaneous. SIFMA fears that expecting dealers to ignore information that they believe in good faith to be relevant is not realistic and would expose them to risk, leading to increased bid-offer spreads and worse prices for customers. In determining fair levels at which to trade bonds, dealers are focused on the market risk involved in establishing or terminating positions. While the factors specified in the guidance contain some important information for dealers in managing their risk, other information may be equally or more important to dealers, such as quotation information or indications of interest in the same or

similar securities. The relevant factors for determining prevailing market price are not the same for every trade. The Hierarchy, however, permits traders to use this information only in very specific circumstances. Therefore, dealers in possession of such information are required to ignore it if the information does not fit into the Hierarchy, or if it fits in a different order in the Hierarchy – even if they, in good faith, consider it important in determining the prevailing market price.

For instance, dealers receive a variety of bid and offer information throughout the trading day, including information from interdealer brokers and customers for securities that the dealers own and for similar securities. Dealers may receive this information orally or electronically (e.g., via facsimile, Bloomberg or other electronic messaging systems, or website access). Dealers view this quotation information as critical in assessing the current market price for a bond because it reveals the demand and supply for a particular security or type of security, which – according to basic economic principles – determines price. In some instances, this information may be more important than prior trades, especially given the open-ended nature of the definition of “contemporaneous cost.” Under this draft guidance, however, dealers may use quotation information for similar securities only if the first three factors in the Hierarchy are not present.

The legal basis underlying the Hierarchy was developed in connection with the equity markets, and largely in the context of “pump and dump” schemes perpetrated by penny stock boiler rooms on retail customers.<sup>6</sup> In contrast to the debt markets, in the equity markets there are registered market makers, consolidated quotation information, and fewer securities. Market makers in equity securities determine prevailing market prices based on current, consolidated quotes, which generally reflect very recent trades. In the debt markets, however, quotations are not published in a consolidated manner (if at all), there are many more securities (most of which trade infrequently), and the market maker concept is more constrained. It is inappropriate, therefore, to import the legal structure developed in the equity context into the very different debt markets. By requiring dealers to look to quotation information *only* if other factors are not present, the draft guidance would require dealers to ignore information that they consider to be critical in pricing securities.

For these reasons listed above, SIFMA requests that the MSRB dismiss the proposed rigid Hierarchy, and instead recognize that dealers need the flexibility to take into account a myriad or menu of factors in determining prevailing market price. Determining the prevailing market price in a broad over the counter market with taxable and tax-exempt components should be based on a set of factors that may be taken into account, without regard to any hierarchy. Those factors are numerous and include, but are not limited to: contemporaneous cost of dealer and customer trades; changes in interest rates; changes in credit quality; news; size of trade; quotes; and liquidity at that point in the yield curve. Other factors include appropriate reference

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<sup>6</sup> See, e.g., *First Independence Group Inc. v. SEC*, 37 F.3d 30, 32 (2d Cir. 1994); *Barnett v. U.S.* 319 F.2d 340, 344 (8th Cir. 1963); *In the matter of Alstead, Dempsey & Co.*, Exchange Act Release No. 20825 (Apr. 5, 1984).

points in the government bond market or muni market, depending on taxability of the bonds, and their perceived value relative to prevailing market prices. Changes in the currency, equities and commodities markets are also examples of factors that can be relevant. Although the proposed interpretive guidance would simplify the process of determining prevailing market price for those conducting surveillance, it would handcuff market participants from taking into account relevant information for pricing, and make them less willing to risk capital.

Administrative Burdens of Contemporaneous Documentation and the Overall Effects of the Guidance on Liquidity in the Municipal Market

Pursuant to the draft interpretive guidance, a dealer must document, on a contemporaneous basis, the facts and circumstances that led it to conclude that the purchase transaction is not indicative of the prevailing market price and also must, on a contemporaneous basis, fully document the manner in which such prevailing market price is otherwise determined. In effect, most trades in municipal securities will require documentation at the time of trade to evidence prevailing market price because due to the sheer number of different municipal securities, most trades in municipal securities will not have a contemporaneous dealer purchase transaction, and the prevailing market price may have to be determined by the Hierarchy of pricing tests, if changes to this approach are not made as we suggest. The contemporaneous production of records of the facts and circumstances of such transactions will add to the burden of this draft guidance. The contemporaneous documentation requirement could be lessened if there was a mere requirement for dealers to have in place policies and procedures setting forth when contemporaneous documentation would be required. Policies could state that significant events that caused major market moves that are widely known are unnecessary to document. Leaving the timing and level of documentation up to a particular firm's risk tolerance would reduce the burden on the industry generally without changing the tenor or result of the draft guidance.

Due to the complexity and administrative burdens potentially added by this draft interpretive guidance, SIFMA feels dealers may be discouraged from committing capital to the municipal securities market, especially to lower-rated securities, retail-sized blocks and any security in a volatile market. Dealers will be less willing to buy securities for their own inventory or otherwise engage in trades that are not crossed due to the amount of price discovery and documentation for compliance purposes required for each transaction. Due to the risk of loss and regulatory risk compared to the potential gain, dealers will be particularly less willing to make markets in those securities that need it the most--illiquid securities, which make up the vast majority of the municipal securities market. Most municipal CUSIP numbers do not trade at all in a given year.<sup>7</sup> Those municipal CUSIP numbers that do trade, trade on average 1.5 times per

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<sup>7</sup> See, SEC Report on Transactions in Municipal Securities (July 1, 2004), available at: <http://www.sec.gov/news/studies/munireport2004.pdf>. The report found that during the study period, about 70% of municipal securities did not trade, and less than 1% of securities accounted for half of the transaction activity.

year.<sup>8</sup> Therefore, we have serious concerns about the impact this draft interpretive guidance may have on municipal market liquidity.

#### Clarification Needed of Documentation Related to News Issued or Otherwise Distributed

SIFMA welcomes the MSRB's inclusion of language recognizing that a dealer's (near) contemporaneous cost may not be indicative of the prevailing market price of a security when news that has an effect on the perceived value of the security has subsequently been disseminated to the market, as we feel that news is one factor of many that should be taken into account. SIFMA asks the MSRB, however, to clarify that such news may be distributed through a variety of channels, and is not limited to information that has been broadly disseminated or made widely available to the marketplace, such as by means of a press release carried over a major news service, a major news publication, or a public filing made with a regulatory agency. The distribution of information through narrower channels may affect the price of a debt security, even if such information has not been broadly disseminated to the marketplace. For this reason, the MSRB should clarify that dealers may be able to rely on information distributed through a variety of channels in proving and documenting that contemporaneous cost may not be reflective of prevailing market price.

In addition, SIFMA requests clarification that "news" includes information that may not directly impact the issuer but may still impact the price of the issuer's debt securities. Again, we feel that news on similar securities or related sectors are one factor of many that should be taken into account to determine prevailing market price. For example, news may come out that a security with similar characteristics is being issued by a different issuer. This may reduce the demand for the first issuer's bonds, although the news about the new issue would not affect the issuer of the first bond per se. We believe that the rule as written is broad enough to encompass this scenario, as the news of the new issue could have an effect on the perceived demand for the issuer's debt securities, and hence the perceived value of the existing debt security. However, we would appreciate it if the MSRB would confirm this understanding.

#### "SMMP" Exclusion Too Limited

SIFMA strongly supports the carve-out of sophisticated municipal market professionals (SMMPs)<sup>9</sup> from the definition of "customer" for purposes of this draft interpretive guidance. This carve-out is consistent with the well-recognized principle that a dealer's relationships with institutional customers are qualitatively different from its relationships with retail customers.

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<sup>8</sup> Member source.

<sup>9</sup> MSRB Rule G-17 Interpretation – Interpretive Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals, April 30, 2002 (the "SMMP Notice").

Currently, the proposed carve-out only applies to trades with SMMPs in “non-investment grade municipal securities.” The draft guidance defines a “non-investment grade municipal security” as a municipal security that: (i) if rated by only one nationally recognized statistical rating organization (“NRSRO”), is rated lower than one of the four highest generic rating categories; (ii) if rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by any of the NRSROs; or (iii) if unrated, either was analyzed as a non-investment grade municipal security by the dealer and the dealer retains credit evaluation documentation and demonstrates to the agencies charged with enforcing MSRB rules (using credit evaluation or other demonstrable criteria) that the credit quality of the security is, in fact, equivalent to a non-investment grade municipal security.

SIFMA requests that the MSRB revise the draft guidance to expand the exclusion from the definition of customer to apply to all municipal bond trades with SMMPs. The institutional investors who qualify for SMMP treatment have sufficient knowledge of the market or certain sectors of the market to trade in municipal securities with broker-dealers at prices negotiated at arms length, reducing the need for such customers to be protected with respect to every transaction under this draft guidance. We believe these principles apply equally to situations where a SMMP engages in all municipal bond transactions regardless of the rating.

In the context of suitability interpretations, it is widely recognized that institutional and retail investors are qualitatively different.<sup>10</sup> The threshold for determining a SMMP is very stringent. First, an institutional investor must be an entity with total assets of at least \$100 million invested in municipal securities in the aggregate in its portfolio and/or under management. When a dealer has reasonable grounds for concluding that an institutional customer (i) has timely access to the publicly available material facts concerning a municipal securities transaction; (ii) is capable of independently evaluating the investment risk and market value of the municipal securities at issue; and (iii) is making independent decisions about its investments in municipal securities, and other known facts do not contradict such a conclusion, the institutional customer can be considered a sophisticated municipal market professional by the dealer.

SIFMA feels a lower threshold may even be appropriate to establish that an institutional investor is a SMMP.<sup>11</sup> Many institutional accounts do, in fact, have the ability not only to assess the intrinsic value of particular debt securities, but also to evaluate independently the market for them. Certain institutional accounts that are active in the debt securities markets employ considerable in-house expertise evaluating potential investments — expertise that at times may

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<sup>10</sup> See SMMP Notice.

<sup>11</sup> We note, for example, that Section 2(a)(51) of the Investment Company Act of 1940 defines a “qualified purchaser” to have an investment portfolio of at least \$5 million for an individual or at least \$25 million for a corporation, partnership or other entity.

be superior to those of bond dealers. These institutional customers include the asset management arms of virtually every multi-service financial services firm, large insurance companies, and hedge funds specializing in a wide range of liquid and illiquid municipal securities. These institutional customers also typically have sales and trading relationships across several investment banks, regularly possess internal research departments with specialized knowledge of the industry sectors in which they invest, direct contact with issuers and obligors, and have access to their own capital in addition to the capital in the dealer market. They also have access to information from multiple dealers as well as trading screens on which they may do comparative requests for quotations among their dealers.

It is important to emphasize that an extension of the carve-out, as we have proposed, would not result in a negative effect for unsophisticated, retail customers because, by definition, these persons would not qualify as SMMPs. Also, less sophisticated institutional investors would be also protected under the current rules because of the high threshold for establishing that an investor qualifies as a SMMP.

Finally, recent market conditions have caused investors and other market participants to analyze their use and reliance on ratings. Ratings are particularly less important to SMMPs, who, as described above, typically have their own staff of analysts who have expertise at evaluating investments. Also, securities may not be trading in the price range of investment grade, even if the rating(s) on that security may be technically investment grade. For example, as the financial guaranty insurers became impaired, trading prices may have reflected the reduced demand for bonds guaranteed by a particular insurer, even if that insurer had not yet been downgraded. As market participants reduce their reliance on ratings, it seems antithetical for the MSRB to put into place new guidance that is dependent on ratings. Therefore, SIFMA does not see the basis for distinguishing between investment grade and non-investment grade municipal bond transactions in determining whether a SMMP should be considered a customer for purposes of the draft guidance.

The “Market Making” Role Played by Dealers in the Bond Markets Should be Acknowledged

SIFMA requests that the MSRB further clarify that debt dealers may be market makers, as the market maker concept is important in determining prevailing market price other than based on contemporaneous cost.

A “mark-up equals the price charged to the customer minus the . . . [bond’s] . . . prevailing market price”<sup>12</sup> and, pursuant to the draft interpretive guidance, dealers must transact

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<sup>12</sup> *Banca Cremi, SA v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1033 (4th Cir. 1997).



with customers at prices reasonably related to this “prevailing market price.” Dealers risking capital in connection with market making activities should, subject to certain conditions, be able to treat the prices at which they are willing to buy (in the case of a customer sale) or to sell (in the case of a customer purchase) as a security’s prevailing market price. Dealers that are not engaged in this type of market making activity generally should instead, under the draft guidance, use a bond’s “contemporaneous cost” as the presumptive measure of its prevailing market price. The SEC has stated that, without this special accommodation to dealers that risk capital, dealers would be deterred “from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity.”<sup>13</sup>

Bond dealers regularly risk their capital to facilitate customer transactions, and regularly provide quotes to customers and in the interdealer market. SIFMA believes that dealers in debt securities may, under certain circumstances, be market makers. Further, SIFMA continues to believe that the MSRB should take into account structural differences between the equity and bond markets in determining whether a debt dealer may be a market maker. SIFMA has in the past requested that the NASD’s mark-up proposal provide specific interpretive guidance on when a dealer in the debt markets may be considered a market maker, and continues to believe that such an approach is appropriate as applied by the MSRB to municipal securities.<sup>14</sup>

SIFMA applauds FINRA for recognizing the market maker concept in the Proposing Release for its mark-up policy for debt securities.<sup>15</sup> Further, SIFMA applauds FINRA for recognizing, in the Zackula Letter, legal precedent for the definition of market maker that has application in the current, decentralized, over-the-counter bond markets, including *Adams Securities Inc.*,<sup>16</sup> *Raymond James & Associates, Inc.*,<sup>17</sup> and *C.R.A. Realty Corporation v. Tri-*

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<sup>13</sup> *In re Peter J. Kisch*, Exchange Act Rel. No. 19005, 1982 WL 529109, at \*5 (Aug. 24, 1982).

<sup>14</sup> See SIFMA Letter to Secretary Nancy M. Morris, dated January 3, 2007, on File No. SR-NASD-2003-141, Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities at: <http://www.sec.gov/rules/sro/nasd/nasd2003141/nasd2003141-8.pdf>.

<sup>15</sup> See Notice of Filing Amendments Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities, Exchange Act Rel. No. 54799 (Nov. 21, 2006), 71 Fed. Reg. 68856, n.8 (Nov. 28, 2006) (the “Proposing Release”). See also, Letter from Ms. Sharon Zackula, Associate General Counsel, NASD, to Ms. Katherine A. England, Assistant Director, Division of Market Regulation, SEC (Oct. 4, 2005) (“Zackula Letter”) Letter, at n.17 (“NASD continues to embrace the concept of market makers in the debt markets”).

<sup>16</sup> *Adams Securities, Inc.*, Admin. Proc. File No. 3-7624, 1993 SEC LEXIS 506, at \*6 (March 9, 1993) (“whether a dealer is acting as a market maker depends on the particular facts and circumstances.”);

<sup>17</sup> *Raymond James Assoc., Inc.*, Admin. Proc. File No. 3-8801, 1997 SEC LEXIS 1581, at \*9-10. The SEC held that Raymond James acted as a market maker in direct participation programs: (i) where it “did not sell these securities to dealers other than [wholly owned subsidiaries] during the two-monthly period under review . . .”; (ii) where its advertising literature referred to the firm as a market maker; (iii) where it did not furnish quotations in an

*South Investments*.<sup>18</sup> SIFMA, however, believes that these points are of sufficient significance to its members that the MRSB should expressly acknowledge that there are market makers in municipal securities as there are in corporate securities and other markets.

#### Size of Transactions Should be Considered

In the draft interpretive guidance, the size of a transaction is not taken into account in the determination of prevailing market price. SIFMA feels strongly that size is one of the factors that dealers take into consideration when evaluating prevailing market price. Transaction size is a relevant factor for not only determining fair price, but also prevailing market price and the mark-up or mark-down of a particular security.

The economic reality is that market values and spreads can differ widely for small trades and institutional-size trades. SIFMA is concerned that dealers, under the draft guidance, will be required to use the prices resulting from small bond trades as the prevailing market price from which they would be required to compute markups on subsequent, institutional-size trades. This could put dealers in a difficult position, requiring them to sell bonds at a price that is lower than the prevailing market price, or buy bonds at a price that is higher than the prevailing market price. Because executing a small trade often requires at least as much (and often more) time and operational resources for a dealer than executing an institutional-size trade,<sup>19</sup> the small trade, even though often charged a smaller dollar price of total mark-up or mark-down, may appear to be charged a somewhat larger mark-up or mark-down, proportionally. However, even if the dealer's mark-up or mark-down is taken out of the equation, the prevailing market price will be different for small trades versus institutional-size trades. This fact is due to a variety of reasons, including the types of investors purchasing each type of lot and their demand for securities. For instance, large portfolio managers are not going to fill their portfolios full of \$5,000 blocks each of different obligor's securities, as the monitoring and credit surveillance of such a portfolio would be unmanageable. Therefore, demand among institutional investors is higher for large blocks of bonds, which affect their prevailing market price, and not just the dealer mark-up or mark-down associated with executing a trade in that block of securities. We request the MSRBB acknowledge that this is a common fact of market behavior (across many markets). If the prevailing market price were derived from the small trades, it would force a dealer to charge a

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interdealer quotation system, although no such system existed and the firm made extensive efforts to distribute its quotes widely; and (iv) where it incurred market risk and added liquidity to a largely illiquid market.

<sup>18</sup> *C.R.A. Realty Corp. v. Tri-South Investments*, 738 F.2d 73 (2nd Cir. 1984) (for purposes of Section 16 of the Exchange Act, a broker-dealer was a market maker in convertible debentures (and the equity security to which debentures were convertible) in an OTC market in which there was no centralized mechanism for publishing bids and offers).

<sup>19</sup> We note that costs are not limited to trade execution. There are costs associated with holding these smaller lots for clients over many years, including interest collection and monitoring corporate actions, such as redemption.

higher all-in price for an institutional-size trade--which the institutional customer simply won't pay--or buy at a lower all-in price for an institutional-size trade--a price at which the institutional customer won't accept. The economic reality that evolves from this is that the dealer will avoid smaller trades that will "set" unrealistic prevailing market prices for institutional-size trades. That impairs liquidity for smaller investors, surely not the intention of the MSRB.

FINRA has recognized that dealers are entitled to a profit,<sup>20</sup> but if dealers cannot make a profit in retail trading, dealers will step away from the retail market, and this guidance will have the unintended affect of reducing liquidity for small trades. Therefore, we request that the MSRB recognize the differences in pricing between institutional-size trades and small trades. Similarly, with large blocks dealers may negotiate discounts or premiums, and this may occur for both investment grade and non-investment grade bonds. Requiring the dealer to use the discounted or premium price as the prevailing market price for the next trade could put the dealer in a difficult position for the reasons discussed above. SIFMA urges the MSRB to permit transaction size to be taken into account and allow dealers to disregard, for purposes of determining prevailing market price, the discount or premium inherent in pricing small or large bond transactions.

#### Prevailing Market Prices and Liquidity in the Municipal Securities Market Generally

There are a myriad of reasons why prevailing market prices may deviate due to unquantifiable market forces. On Day A, a dealer may get 5 bids on a bid wanted listing, with a high bid of 103.5 and a low bid of 101. On Day A, the bid side is established to be 103.5. The next day, Day B, no major market shift may have occurred, but the top two bidders for that type of security do not bid. The top two bidders may not have bid for any number of reasons, including they do not want to risk their capital that day, their portfolios are full with that name or type of credit, or their portfolios are full for that point in the yield curve. The bid side on Day B becomes 101. Liquidity ebbs and flows in the market, and is not constant. Liquidity for a particular deal typically becomes thinner the older it gets. Liquidity for transactions that have recently been issued is fairly high, with a steep drop in liquidity as the issue matures.<sup>21</sup>

Another factor that determines market liquidity on a particular day is the level of supply of bonds. There have been a number of recent examples of leveraged counterparties needing to sell large amounts of bonds in the wake of collateral calls. In this scenario, it is not the securities that are distressed, but it is the seller that is distressed. In a market where supply greatly surpasses demand, the prevailing market price for securities will decrease until the level at which market participants are willing to commit capital, if they have investable capital.

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<sup>20</sup> Securities and Exchange Commission Release No. 34-53562; File No. SR-NASD-2006-005 (March 29, 2006).

<sup>21</sup> See MSRB 2009 Factbook at p. 16.

### The Definition of “Contemporaneous Cost” Should be Clarified

The prevailing market price provides the baseline from which the dealer must calculate any mark-up. The method for determining prevailing market price, therefore, is critical to any mark-up analysis. The draft guidance presumes that contemporaneous cost in the inter-dealer market is the best evidence of prevailing market price. SIFMA and its members feel that contemporaneous cost should be merely one factor of many that is factored into the analysis of prevailing market price.

SIFMA urges the MSRB to provide additional clarification on the definition of “contemporaneous cost” because this definition lacks objective standards and will be difficult for dealers to apply. In particular, SIFMA requests that the MSRB provide additional guidance on the meaning of “contemporaneous,” including (1) clarifying that time is not the only factor that may cause trades to not be contemporaneous and (2) clarifying that a dealer’s good faith determination that trades are not “contemporaneous” will be considered in determining if a price is contemporaneous.

SIFMA believes these clarifications are critical because the proposed definition of contemporaneous is circular and subjective. The word contemporaneous means “originating, existing, or happening during the same period of time.”<sup>22</sup> Under the draft guidance, a dealer’s cost is “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 security . . . .” As such, contemporaneous transactions are close enough in time if they happen during the same time period, a circular definition that is difficult for dealers to apply. Further, the passage of time appears to be the only factor in determining whether or not a prior trade is considered contemporaneous with a subsequent trade.

As a matter of logic, it must be the case under the draft guidance that as more time passes between transactions, the less likely the transactions would be deemed to be contemporaneous. The amount of time that must elapse, however, appears to be an elastic concept, based on “reasonable expectations.” It must be understood that this circular definition combined with the lack of objective standards for determining whether transactions are contemporaneous makes the definition quite difficult to apply in practice. It should be noted that in a highly volatile market, the entire market could move in mere minutes, whereas in a stable market there may be no significant movement for days or weeks. Market volatility is a critical component in determining which trades may be contemporaneous at a given time, or which prices may be irrelevant. Accordingly, a dealer’s good faith determination that a prior trade is not contemporaneous should be considered in determining if a price is contemporaneous.

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<sup>22</sup> THE AMERICAN HERITAGE COLLEGE DICTIONARY (4th ed. 2002).

SIFMA and its members would like to request clarification on a few related matters, such as the reason, in Illustration 4, contemporaneous cost is not reflective of the most recent purchase from customer C, but instead is tied to a prior purchase from customer B. SIFMA also would like to confirm that in Illustration 8, it is Dealer B and not A that must fully document, on a contemporaneous basis, the facts and circumstances that led it to conclude that the purchase transaction is not indicative of the prevailing market price. In that same illustration, SIFMA would like to clarify that it appears if Dealer B purchased the bonds from Dealer A at a price above the prevailing market price, then Dealer B would have to take a loss if it immediately sold the bonds to a customer, as Dealer B would have to sell the bonds at a fair price. However, if Dealer B purchased the bonds from Dealer A at a price below the prevailing market price, then Dealer B would have to use that mark as the prevailing market price, and would not be able to get the benefit of its bargain by selling the bonds to a customer at their fair price. Finally, SIFMA would like to point out that in the application of NASD IM-2440-2, the definition of prevailing market price is not limited to the contemporaneous cost of inter-dealer trades, but that customer trades are included as well. Some SIFMA Members note that their surveillance and monitoring systems are designed for compliance with IM-2440-2, and that applying such a change to current systems to account for a different rule in municipal securities would cause significant expense. They therefore feel strongly that any reference to contemporaneous cost should not be limited to interdealer trades, but that it should include customer trades as well.

#### Price Transparency

SIFMA members also feel strongly that the MSRB's Electronic Municipal Market Access website should include prominent disclosure notifying investors that the trade prices disclosed on EMMA include a dealer's mark-up or mark-down. Generally prices across all fixed income markets are quoted or reported inclusive of the dealer's mark-up or mark-down; however, equity market prices are generally quoted without the dealer's commission. SIFMA members feel that this difference in how prices are quoted across markets may be causing confusion among retail investors, and others who use the EMMA data for price transparency but who may not be sophisticated fixed income investors. In order to avoid misleading the public, SIFMA urges the MSRB to make such changes to EMMA to clearly inform users of the EMMA data that the prices include dealer mark-up or mark-down.

#### Conclusion

For the reasons discussed above, SIFMA and its members are concerned that the draft interpretive guidance, as written, will reduce liquidity by impinging on a dealer's ability to use its best judgment and all market information in determining the prevailing market price of a security. SIFMA respectfully requests that the MSRB: (1) allow for a more flexible approach in determining prevailing market price by dismissing the concept of a rigid hierarchy in favor of an approach that recognizes pricing is based on a myriad of factors (2) permit a more flexible

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approach to documenting transactions; (3) expand the exemption from the guidance to include all transactions by dealers with a SMMP; (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker; and (5) provide dealers with more guidance regarding the definition of “contemporaneous cost”. Further, given the potential significance of this draft interpretive guidance on the market, we would welcome the opportunity to meet with the MSRB to discuss our concerns. Again, we appreciate this opportunity to comment on this draft interpretive guidance. If you have any questions concerning these comments, or would like to discuss these comments further, please feel free to contact the undersigned at 212.313.1130 or via email at [lnorwood@sifma.org](mailto:lnorwood@sifma.org).

Respectfully,

A handwritten signature in black ink, appearing to be 'L. Norwood', written in a cursive style.

Leslie M. Norwood,  
Managing Director  
and Associate General Counsel

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cc: ***Securities Industry and Financial Markets Association***  
Municipal Executive Committee  
Municipal Legal Advisory Committee  
Municipal Syndicate & Trading Committee  
Municipal Operations Committee  
Regional Dealers Fixed Income Committee  
Retail Fixed Income Committee