



New markup disclosure rules: Change is fast approaching

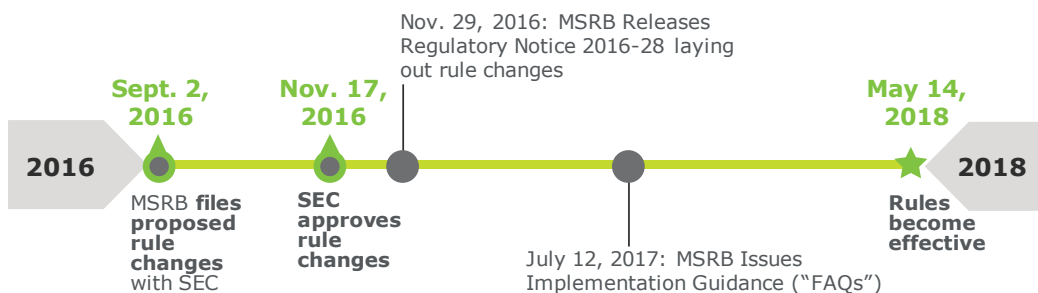
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Executive Summary

The Municipal Securities Rulemaking Board (“MSRB”) and Financial Industry Regulatory Authority (“FINRA”) have amended rules G-15, G-30 and FINRA Rule 2232 to require dealers to disclose the compensation received (referred to as “markups” throughout) on certain municipal and corporate debt transactions. These disclosures must appear on confirmations sent to non-institutional (“retail”) clients, based on the security’s prevailing market price (“PMP”). The rules were approved by the Securities and Exchange Commission (“SEC”) in November 2016, with both FINRA and the MSRB publishing implementation related guidance (“FAQs”) on July 12, 2017.¹ The rules become effective on May 14, 2018. This paper focuses primarily on the amendments to MSRB Rules G-15 and G-30 and the potential challenges and focus areas for firms impacted by these changes.

Figure 1.1: Rule amendment timeline

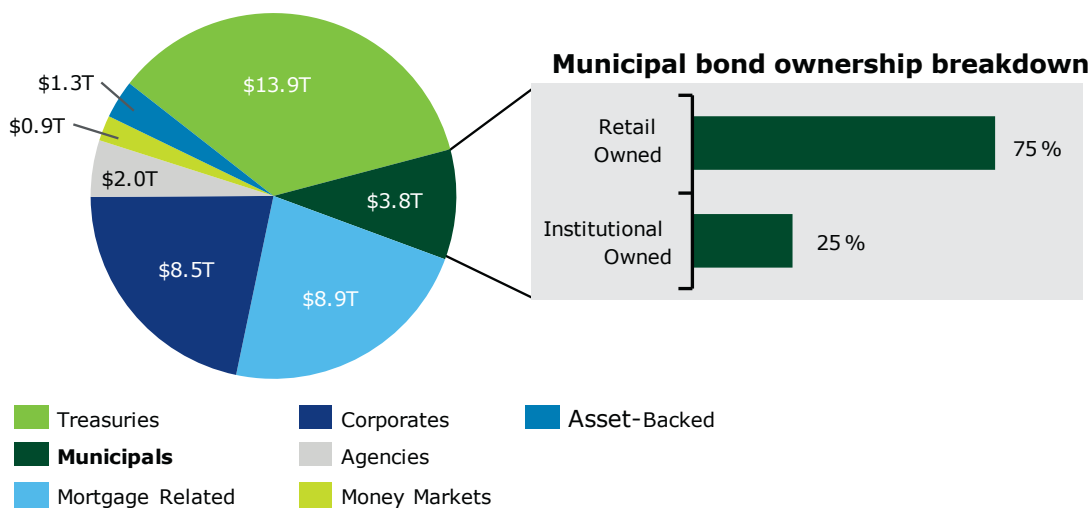


Aimed at providing more transparency to retail clients, the MSRB has provided certain prescriptive requirements associated with determining the PMP using a “waterfall” analysis. However, a number of aspects within the analysis still require subjective determinations. Accordingly, impacted firms must conduct extensive and potentially onerous processes to demonstrate that the PMP used to determine a markup or markdown is consistent with MSRB rules. Further, the MSRB FAQs reiterated the May 14, 2018 rule effective date, leaving a compressed window for the industry to develop and/or implement technology solutions to automate the waterfall analysis and continuing to rebuff industry requests for rule delay or other relief.

Retail Municipal Bond Marketplace Overview

As of 2016 year end, municipal bonds made up roughly \$3.8 trillion of the approximate \$40 trillion US bond marketplace³. Through direct ownership or mutual fund investments, it is estimated that retail investors own 75% of outstanding municipal bonds⁴. Additionally, given their popularity due to the potentially beneficial tax treatment and given that 80% of transactions occur at or below the \$100,000 level⁵, it is reasonable to presume that retail investors are significant participants in the secondary market for municipal securities.

Figure 2.1: Outstanding US bond marketplace breakdown (\$ trillions)⁶



The MSRB has indicated that, in conjunction with its best execution rules (G-18), the amended markup disclosure rule is meant to ensure retail investors receive:

- the best possible PMP for their order
- a clear understanding of the commission charged by the dealer in executing the order

Intent of Amended Rules

Based on its initial analysis, the MSRB estimates that markup disclosure requirements triggered by the amended rules will impact an estimated 8,000 retail investor transactions per day.⁷

Understanding the nature and intent of this rule requires a quick comparison with the current equities market. The equities market and its associated structure has fundamentally changed following the paper crisis of the late 1960s. Today, retail equity investors have ready access to:

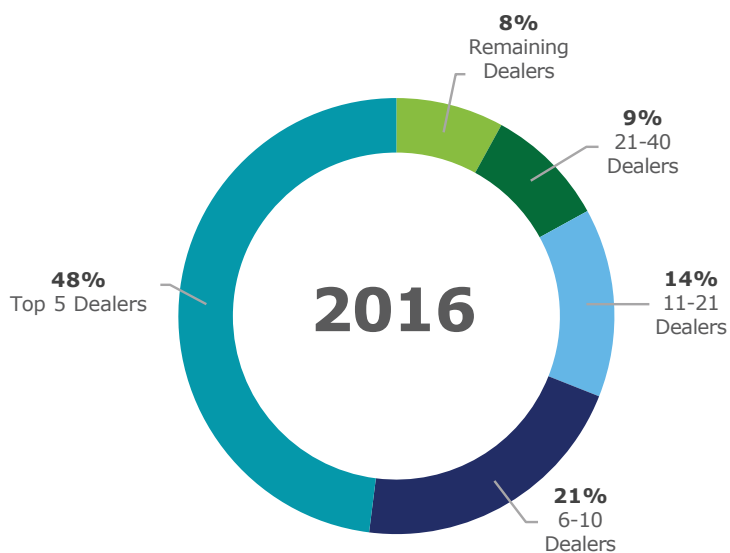
- information needed to make an informed investment decisions including streaming quotes and real-time information from exchanges
- a variety of electronic trading venues and platforms to buy and sell listed equities, including self-directed brokerage platforms
- standardized pre-trade, post-trade, and settlement activities, including confirmation statement disclosures governed by SEC Rule 10b-10, requiring—among other things—commissions to be clearly documented

In contrast, the municipal security market remains entirely over-the-counter. While the use of technology in the municipal markets continues to evolve as an enabler, the comparatively slow adoption of electronic trading venues leaves many dealers continuing to rely on unstructured forms of communication (voice and chat), resulting in limited transparency for price discovery.

Additionally, the sheer number of outstanding municipal bond issuances (more than one million vs. under four-thousand listed equities)⁸ and consistent stream of new offerings coming to market means liquidity is comparatively limited. The SEC, itself noted in their 2012 *Report on the Municipal Securities Market*⁹:

The municipal securities market is characterized by relatively low liquidity and, following the initial distribution period, municipal securities trade only infrequently...in 2011, about 99% of outstanding municipal securities did not trade on any given day. For those bonds that do trade, the number is very low, averaging only 14 customer trades during the first sixty days after issuance.

Figure 3.1: Distribution of customer trades (based on par amount traded)¹¹



Furthermore, the number of registered municipal dealers continues to fall. Since 2012, MSRB registered dealers have decreased by nearly 20%, to 1,448.¹⁰ Additionally, trade executions are highly concentrated among a small subset of dealers. MSRB data from 2016 shows that 83% of all customer trades were executed by the top 20 dealers.¹¹

The structural issues described above make price discovery in the municipal bond market opaque. Accordingly, the intent of the amended rules is to provide retail investors with the visibility and transparency to understand how the markups on their completed municipal transaction is calculated, and the related impact on the economics of their completed transaction.

Markup Disclosure, Prevailing Market Price and New Books & Records Requirements

According to the amended rules, the markup disclosure requirement is triggered:

...on a transaction in municipal securities with a non-institutional customer if the dealer also executes one or more offsetting principal transaction(s) on the same trading day as the customer transaction in an aggregate trading size that meets 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 MSRB Rule G-8(a)(xi).

In simplified terms, the rule effectively requires the disclosure of the markup on a transaction based on the PMP when a security is bought from or sold to a retail customer on the same day as the security is bought or sold for the dealer's own account.¹²

Prevailing Market Price Waterfall Analysis

Not only does the rule layout when a disclosure is required, but it also details how the markup must be disclosed, requiring that the markup amount be shown on customer statements as both a total dollar amount and a percentage of the PMP.

Amended rule G-30 lays out the factors for arriving at the PMP, referred to as a "waterfall" guidance or analysis. Dealers are required to use this analysis to calculate the compensation which is to be reflected on customer confirmations. The steps and hierarchy of the waterfall analysis are as follows:

1. Dealers must review contemporaneous trades of the same security with other dealers or customers to establish PMP. If no data matching this criteria is available, dealers may then look to, in order:
 - A. contemporaneous interdealer trades
 - B. trades between other dealers and institutional investors
 - C. trades on alternative trading systems or other electronic platforms

If using a contemporaneous customer trade to determine PMP, the MSRB reminds dealers to adjust its contemporaneous cost or proceeds from that customer transaction to account for the markup included in the price.

What may present difficulty for firms is determining their definition of “contemporaneous.” The MSRB does not mandate a time frame in which trades are to be considered contemporaneous, instead putting the onus on dealers to arrive at their own definition, stating:

Dealers may establish an objective set of criteria to determine whether a trade is contemporaneous, provided the objective criteria are established based on the exercise of reasonable diligence.

The MSRB also makes clear that dealers are expected to adopt and implement policies and procedures necessary to determine contemporaneous trades and ensure those policies and procedures are applied consistently.

2. If contemporaneous trade data is unavailable for the same security, dealers can look at contemporaneous trades of “similar securities.” The MSRB identifies factors including, credit quality, issue size and comparable yield as potential considerations for finding similar securities.

As with contemporaneous trades, the MSRB does not give explicit instructions on determining “similar securities,” instead directing dealers to consider the factors listed above but noting that these are not to be viewed as exhaustive factors. Adding more uncertainty and complexity to the determination of PMP based on similar securities is that the MSRB notes:

...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...

Dealers are expected to establish reasonable metrics for identifying similar securities, and ensuring such standards are accurately and consistently applied. The MSRB has noted that so long as they are reasonable, dealers may look to leverage existing policies and procedures adopted to identify similar securities for the purposes of complying with best execution standards.

3. The “base” of the waterfall analysis, or last resort if none of the earlier steps have data available to support a PMP determination, dealers may rely on prices or yields derived from economic models. Such economic models are expected to take into account such factors 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.

Potential New Books and Records Requirements

Separate and distinct from the requirement to disclose the markup on certain transactions within a customers' confirmation statement, dealers should be aware of and consider that the amendments to Rule G-15 and G-30 may create new books and records requirements. The MSRB explicitly calls out these books and records requirements within response 3.28 of their FAQs, stating:

...The MSRB believes that dealers should keep records to demonstrate their compliance with Rule G-30, particularly where they have the evidentiary burden to demonstrate why a contemporaneous transaction was not the best measure of PMP for a given trade. The MSRB further notes that it would expect PMP documentation to be an important component of a firm's system to supervise compliance with Rules G-15 and G-30.



Some Key Takeaways

Prepare for the knowns: While many subjective determinations remain for dealers when performing calculations necessary for compliance, the MSRB has provided guidance for much of the rule including the steps within the PMP waterfall analysis. With the effective date fast approaching, dealers should be preparing for known requirements and carefully consider existing processes which may be useful as a starting point, such as current best execution processes and controls.

Time is running out to implement technology solutions: The MSRB makes it clear that dealers may rely on technology solutions, including third-party vendors for some or all of the PMP waterfall analysis. A number of vendors have brought technology solutions to market purported to automate the process; however, firms should consider the time requirements of any large scale technology implementation with the rule effective less than a year away.

Vendor solutions don't alleviate the dealer's compliance responsibility: Dealers should recognize that any vendor solutions are still reliant on certain subjective determinations and that the dealer ultimately retains the responsibility for ensuring compliance with all applicable rule provisions.

If relying on a technology solution, whether outsourced or proprietary, a dealer is expected to conduct a robust due diligence process to ensure the underlying steps and calculations performed by the chosen solution adheres to the policies and procedures adopted by the firm.

Books & records policies and procedure require updates: Whether a dealer chooses to rely on a third-party vendor solution, build an in-house technology solution, or rely on a fully manual process, the dealer must ensure that policies and procedures are in place designed to apply the chosen process accurately and consistently in all instances. Additionally, all relevant sections of a dealer's policies and procedures must be updated to accurately reflect the policy and process changes being made to support rule compliance.

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Endnotes

1. MSRB Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions - July 12, 2017 and FINRA Fixed Income Confirmation Disclosure: Frequently Asked Questions (FAQ)
2. MSRB Rule G-30, Supplementary Material .06 Mark-Up Policy
3. SIFMA 2016 Total US Bonds Outstanding
4. Statement of Matthew F. Andresen on Behalf of Headlands Global Markets, LLC before the US House of Representatives Subcommittee on Capital Markets, Securities, and Investment, July 14, 2017
5. MSRB Fact Book 2016 at 37
6. SIFMA 2016 Total US Bonds Outstanding
7. Municipal Securities Investors to Gain Access to Dealer Compensation Information, MSRB Press Release dated November 18, 2016
8. Statement of Matthew F. Andresen on Behalf of Headlands Global Markets, LLC before the US House of Representatives Subcommittee on Capital Markets, Securities, and Investment, July 14, 2017
9. SEC Report on the Municipal Securities Market at 113, July 31, 2012
10. MSRB Fact Book 2016 at 30
11. MSRB Fact Book 2016 at 30
12. Three specific exemptions exist to the disclosure requirement. See amended MSRB Rule G-15(a)(i)(F)(2) for further details



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