

MEMO# 24268

April 27, 2010

MSRB Proposes Guidance on Prevailing Market Prices and Mark-Ups; Conference Call May 3

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TO: MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 13-10
FIXED-INCOME ADVISORY COMMITTEE No. 5-10 RE: MSRB PROPOSES GUIDANCE ON
PREVAILING MARKET PRICES AND MARK-UPS; CONFERENCE CALL MAY 3

The Municipal Securities Rulemaking Board (“MSRB”) is seeking comment on draft interpretive guidance would address establishment of the prevailing market price and the calculation of mark-ups/mark-downs for municipal securities transactions effected by brokers, dealers or municipal securities dealers (“dealers”) in a principal capacity. [\[1\]](#) The guidance would be similar to that established by the Financial Industry Regulatory Authority (“FINRA”) for purposes of other types of debt securities, but would take into account the unique characteristics of the municipal securities markets.

Comments on the proposed interpretive guidance are due to the MSRB no later than June 4, 2010. We will hold a conference call on Monday, May 3, at 3:00 p.m. Eastern time to discuss the Institute’s comments, if any, relating to the MSRB’s guidance. If you plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at 202-326-5833 to receive the dial-in information.

I. MSRB Rule G-30(a)

MSRB Rule G-30(a) provides that a dealer shall not purchase or sell municipal securities for its own account from a customer except at an aggregate price (including any mark-

down/mark-up) that is fair and reasonable, taking into consideration all relevant factors. In analyzing whether a price is fair and reasonable, two principles are used: (1) the customer's price must be reasonably related to the market value of the municipal securities in the transaction and (2) the mark-up or mark-down on a transaction must not exceed a fair and reasonable amount. Mark-ups and mark-downs are calculated from the "prevailing market price."

II. Prevailing Market Price

The proposed guidance would set forth the process by which a dealer should determine the prevailing market price. It also would provide a series of examples to assist dealers in applying the guidance properly.

A. Contemporaneous Cost

The guidance would establish a presumption that the prevailing market price is established by referring to the dealer's contemporaneous costs as incurred, or proceeds as obtained, for a transaction entered into by the dealer in a particular municipal security near in time to a customer transaction in the same security (if such a transaction exists). Countervailing evidence of the prevailing market price could be considered only where the dealer made no contemporaneous purchases/sales in the security or can show that, in the particular circumstances, the dealer's contemporaneous cost is not indicative of the prevailing market price. Under the proposed guidance, a dealer's cost, or proceeds, would be considered contemporaneous if the transaction occurs close enough in time to the customer transaction that it would reasonably be expected to reflect the current market price for the municipal security.

B. Overcoming the Presumption of Contemporaneous Cost

The proposed guidance would provide that a dealer may be able to demonstrate that its contemporaneous cost is, or proceeds are, not indicative of prevailing market price in instances where: (i) interest rates or yields changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in municipal securities pricing; (ii) the credit quality of the security changed significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the security after the dealer's contemporaneous transaction. To prove its case, a dealer would be required to retain contemporaneously produced records of the facts and circumstances and such other evidence that support its position.

C. Pricing Information to Consider When Not Using Contemporaneous Cost

Under the proposed guidance, if the dealer has established that its cost is, or proceeds are, no longer contemporaneous, the dealer must consider, in the order listed, the following types of pricing information to determine prevailing market price. In reviewing the pricing information available within each category, the relative weight of such information depends on the facts and circumstances of the comparison transaction or quotation.

- Prices of any contemporaneous inter-dealer transactions in the security;
- Prices of contemporaneous dealer purchases or sales in the security from or to institutional accounts with which any dealer regularly effects transactions in the same security; or
- For actively traded municipal securities, contemporaneous bid or offer quotations for the security made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

If the above factors are not available, the proposed guidance would permit the consideration of other factors including, but not limited to, the following (in no specific order):

- Prices of contemporaneous inter-dealer transactions in a “similar” municipal security (as discussed below) or prices of contemporaneous dealer purchase or sale transactions in a “similar” municipal security with institutional accounts with which any dealer regularly effects transactions in the “similar” security with respect to customer mark-ups or mark-downs;
- Yields calculated from prices of contemporaneous inter-dealer transactions in “similar” municipal securities;
- Yields calculated from prices of contemporaneous dealer purchase or sale transactions with institutional accounts with which any dealer regularly effects transactions in “similar” municipal securities with respect to customer mark-ups or mark-downs; and
- Yields calculated from validated contemporaneous inter-dealer bid or offer quotations in “similar” municipal securities for customer mark-ups or mark-downs.

If information concerning the prevailing market price still cannot be obtained (e.g., because of lack of active trading), dealers and the agencies charged with enforcing MSRB rules may consider the prices or yields derived from economic models that take into account measures such as credit quality, interest rates, industry sector, and coupon rate. The models currently may be in use by bond dealers or may be specifically developed by the enforcement agencies for surveillance purposes.

D. Evidentiary Value of Isolated Transactions

The proposed guidance would state that isolated transactions or quotations generally would have little or no weight or relevance in establishing prevailing market price. Accordingly, a dealer seeking to demonstrate that an isolated contemporaneous transaction is not indicative of the prevailing market price must retain contemporaneously produced records of the facts and circumstances and such other evidence to support its position, including sufficient evidence to support the prevailing market price otherwise determined for such transaction consistent with the proposed guidance.

E. SMMPs Not Considered Customers

Under the proposed guidance, a “customer” would not include a sophisticated market professional (“SMMP”) that is purchasing or selling a non-investment grade municipal security when the dealer has determined that the SMMP has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in

deciding to enter into the transaction. [\[2\]](#)

III. “Similar” Municipal Securities

The proposed guidance would set forth a series of factors to evaluate whether a municipal security is sufficiently “similar” to the security for which the dealer is determining the prevailing market price (“subject security”).

A. Reasonable Alternative Investment

According to the guidance, a similar security would be one that could serve as a reasonable investment alternative to the investor and, at a minimum, the market yield for the subject security could be fairly estimated from the yields of the similar security or securities. Appropriate consideration could also be given to the prices or yields of the various components of the security in situations where the security has several components.

B. Factors to Consider

The proposed guidance would include the following non-exclusive list of factors for consideration of whether a security is similar to the subject security:

- Credit quality considerations, such as whether the 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;
- The extent to which the spread at which the similar security trades is comparable to the spread at which the subject security trades;
- General structural characteristics and provisions of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the similar security will be called, tendered or exchanged, and other embedded options, as compared with the characteristics of the subject security;
- 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
- The extent to which the federal and/or state tax treatment of the similar security is comparable to such tax treatment of the subject security.

C. Inapplicability to “Story” Bonds

The guidance would provide that a security is not sufficiently similar to be used to establish the prevailing market price when the subject 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.

endnotes

[1] See MSRB Notice 2010-10 (April 21, 2010), available at:
<http://www.msrb.org/msrb1/whatsnew/2010-10.asp>.

[2] The guidance would define SMMP as found in Rule G-17 Interpretation - Interpretive Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals, April 30, 2002 ("SMMP Notice"), available at:
<http://www.msrb.org/msrb1/rules/notg17.htm>. The dealer would need to make its determination regarding the SMMP after considering the factors set forth in the SMMP Notice.