Confirmation Disclosure And Prevailing Market Price Guidance: Frequently Asked Questions - March 19, 2018

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Source: MSRB Rules and Interpretations (http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-15.aspx?tab=2)

Effective May 14, 2018, amendments to MSRB Rule G-15 require dealers to disclose additional information on retail customer confirmations for a specified class of principal transactions, including the dealer's mark-up or mark-down as determined from the prevailing market price (PMP) of the security. Dealers generally also are required to disclose on retail customer confirmations the time of execution and a security-specific URL to the MSRB's Electronic Municipal Market Access (EMMA®) website.[1] Related amendments to Rule G-30, on prices and commissions, provide guidance on determining the PMP for the purpose of calculating a dealer's mark-up or mark-down and for other Rule G-30 determinations.

Also, effective May 14, 2018, amendments to Financial Industry Regulatory Authority (FINRA) Rule 2232 create similar confirmation disclosure requirements for other areas of the fixed income markets. Among other things, the FINRA amendments require dealers to determine their disclosed mark-ups and mark-downs from the PMP of the security that is traded, in accordance with existing guidance under FINRA Rule 2121.

Below are answers to frequently asked questions (FAQs) about the confirmation disclosure requirements under Rule G-15 and related PMP guidance under Rule G-30, Supplementary Material .06 (also referred to as the "waterfall" guidance or analysis). While these FAQs address MSRB rules only, FINRA has also issued guidance for the FINRA rules applicable to agency and corporate bonds. The MSRB and FINRA worked together to produce this guidance. While each has published its own version to refer to MSRB and FINRA rules and materials, respectively, the versions are materially the same and reflect the organizations' coordinated approach to enhanced confirmation disclosure for debt securities. To the extent the MSRB and FINRA offer different guidance based on differences between the markets for corporate, agency and municipal securities, those differences are discussed in the context of the relevant question and answer.

During the implementation period, the MSRB will continue to work with dealers on questions related to the confirmation disclosure requirements and PMP guidance. Dealers are encouraged to contact the MSRB to suggest additional topics or questions for inclusion in the FAQs. Accordingly, the MSRB may add to, update or revise this guidance. The most recent date for the content of an answer will be clearly marked.

For ease of reference, unless otherwise noted, the term "mark-up" refers both to mark-ups applied to sales to customers and mark-downs applied to purchases from customers, and the term "contemporaneous cost" refers both to contemporaneous cost in the context of sales to customers and contemporaneous proceeds in the context of purchases from customers.

G-15 & G30 MSRB Rule Changes

1.1 When does Rule G-15 require mark-up disclosure?

A dealer is required to disclose on a customer confirmation the mark-up 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).

As noted during the MSRB's confirmation disclosure rulemaking process, any intentional delay of a customer execution to avoid triggering the mark-up disclosure requirements may violate Rule G-18, on best execution, and Rule G-17, on conduct of municipal securities and municipal advisory activities.

1.2 Is mark-up disclosure required only where the sizes of same-day customer and principal trades offset each other?

Yes. Mark-up disclosure is required only where a customer trade offsets a same-day principal trade in whole or in part. For example, if a dealer purchased 100 bonds at 9:30 a.m., and then, as principal, satisfied three non-institutional customer buy orders for 50 bonds each in the same security on the same trading day without making any other purchases of the bonds that day, mark-up disclosure would be required only on two of the three customer purchases, since one of the trades would need to be satisfied out of the dealer's prior inventory rather than offset by the dealer's same-day principal transaction.

1.2.1 Are position moves between separate desks within a firm considered "transactions" for purposes of determining whether a dealer has offsetting transactions that trigger a mark-up disclosure requirement?

No. Mark-up disclosure is triggered under Rule G-15 when a customer trade is offset by one or more "transactions." For purposes of the rule, the MSRB considers a "transaction" to entail a change of beneficial ownership between parties. Accordingly, if a retail desk within a dealer acquires bonds through a position move from another desk within the same firm and then sells those bonds to a non-institutional customer, the dealer is required to provide the customer with mark-up disclosure only if the dealer bought the bonds in one or more offsetting transactions on the same trading day as the sale to the customer (subject to the exceptions discussed in Question 1.7).

1.3 When are trades executed by a dealer's affiliate relevant for determining whether the mark-up disclosure requirements are triggered?

If a dealer's offsetting principal trade is executed with a dealer affiliate and did not occur at arm's length, the dealer is required to "look through" to the time and terms of the affiliate's trade with a third party to determine whether mark-up disclosure is triggered under Rule G-15. On the other hand, if the dealer's transaction with its affiliate is an arms-length transaction, the dealer would treat that transaction as any other offsetting transaction (i.e., the dealer would not "look through" to the time and terms of the arms-length transaction).

1.4 What is considered an "arms-length transaction" when considering whether a dealer must "look through" to the time and terms of an affiliate's trade?

The term "arms-length transaction" is defined in Rule G-15(a)(vi)(I) to 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. The MSRB has noted that as a general matter, it expects the competitive process used in an arms-length transaction to be one in which non-affiliates have frequently participated. In other words, the MSRB would not view a process, like a request for pricing protocol or posting of bids and offers, as competitive if non-affiliates responded to requests or otherwise participated in only isolated or limited circumstances.

Factors that may be relevant to a dealer's determination that a transaction with an affiliate was conducted at arm's length include, but are not limited to:

counterparty anonymity during the competitive process to the time of execution; the presence of other competitive bids or offers, in addition to the affiliate's, in the competitive process; contemporaneous market activity in the same or a similar security (or securities) which is used to evaluate the relative competitiveness of bids or offers received during a competitive process; and a lack of preferential arrangements between the affiliates concerning, or based on, the handling of orders between them. The MSRB notes that no one of these factors is necessarily determinative on its own.

1.5 If a dealer has an exclusive agreement with a non-affiliated dealer under which it always purchases its securities from, or always sells its securities to, that non-affiliate, would the "look through" requirements apply when the dealer transacts with the non-affiliate?

No. The "look through" applies only to certain transactions between affiliated dealers. Under Rule G-15, a "look through" is required when the dealer's offsetting transaction is with an affiliate and is not an "arms-length transaction." A transaction with a non-affiliate would not meet these conditions, so a "look through" would not be required. The MSRB notes that dealers should continue to evaluate the terms and circumstances of any such arrangements in light of other MSRB rules and guidance, including best execution. In evaluating these terms and circumstances, dealers should consider whether they diminish the reliability and utility of mark-up disclosure to investors.

1.6 Does the mark-up disclosure requirement in Rule G-15 apply to transactions that involve a dealer and a registered investment adviser?

No. To trigger the mark-up disclosure requirement in Rule G-15, a dealer must execute a trade with a non-institutional customer. Under the rule, registered investment advisers are institutional customers; accordingly, mark-up disclosure is not required when dealers transact with registered investment advisers. This is the case even where the registered investment adviser with whom the dealer transacted later allocates all or a portion of the securities to a retail account or where the transaction is executed directly for a retail account if the investment adviser has discretion over the transaction. The MSRB notes that this answer is specific to the mark-up disclosure requirement in Rule G-15; it is not intended to alter any other obligations.

1.7 Are there any exceptions to the mark-up disclosure trigger requirements?

Yes. There are three exceptions. First, disclosure is not required for transactions in municipal fund securities. Second, mark-up disclosure is not necessarily triggered by principal trades that a dealer executes on a trading desk that is functionally separate from a trading desk that executes customer trades, provided the dealer maintains policies and procedures reasonably designed to ensure that the functionally separate trading desk had no knowledge of the customer trades. For example, the exception allows an institutional desk within a dealer to service an institutional customer without necessarily triggering the disclosure requirement for an unrelated trade performed by a separate retail desk within the dealer. Third, disclosure is not required for transactions that are list offering price transactions, as defined in paragraph (d)(vii)(A) of Rule G-14 RTRS Procedures.

1.8 May dealers voluntarily provide mark-up disclosure on additional transactions that do not trigger mandatory disclosure?

Yes. In disclosing this information on a voluntary basis, dealers should be mindful of any applicable MSRB rules. For example, while mark-up disclosure is voluntary for trades that are not triggered by the relevant provisions of Rule G-15, the process for determining the PMP according to Rule G-30 applies in all cases. In addition, to avoid customer confusion, voluntary disclosure should also follow the same format and labeling requirements applicable to mandatory disclosure.

1.9 In arrangements involving clearing dealers and introducing or correspondent dealers, who is responsible for mark-up disclosure?

The introducing or correspondent dealer bears the ultimate responsibility for compliance with the disclosure requirements under Rule G-15. Although an introducing or correspondent dealer may use the assistance of a clearing dealer, as it may use other third-party service providers subject to due diligence and oversight, the introducing or correspondent dealer remains ultimately responsible for compliance.

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