UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
INVESTOR ADVOCATE

March 31, 2016

Submitted Electronically

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1300 I Street NW, Suite 1000
Washington, D.C. 20005

RE: Regulatory Notice 2016-07
Request for Comment on Draft Amendments to MSRB Rule G-30 to Provide Guidance on Prevailing Market Price

Dear Mr. Smith:

The Office of the Investor Advocate[1] appreciates this opportunity to provide comments in regard to Regulatory Notice 2016-07, Request for Comment on Draft Amendments to Municipal Securities Rulemaking Board ("MSRB" or "Board") Rule G-30 to Provide Guidance on Prevailing Market Price ("MSRB Request for Comment").[2] The MSRB Request for Comment broadly establishes the manner in which the prevailing market price (the "PMP") for municipal securities is calculated.[3]

[1] This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Securities and Exchange Commission ("Commission" or "SEC"), the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein.

[2] Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78d(g)(4), the Office of the Investor Advocate at the Securities and Exchange Commission is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations. In furtherance of this objective, we routinely review and examine the impact on investors of significant rulemakings of the Municipal Securities Rulemaking Board. As appropriate, we make recommendations and utilize the public comment process to help ensure that the interests of investors are considered while rulemaking decisions are made; MSRB, Regulatory Notice 2016-07, *Request for Comment on Draft Amendments to MSRB Rule G-30 to Provide Guidance on Prevailing Market Price* (Feb. 18, 2016), http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2016-07.ashx?n=1.

[3] MSRB, Regulatory Notice 2016-07, *Request for Comment on Draft Amendments to MSRB Rule G-30 to Provide Guidance on Prevailing Market Price* (Feb. 18, 2016), http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2016-07.ashx?n=1.

In prior comment letters, the Office of the Investor Advocate voiced its support for the adoption of rules requiring the disclosure of same-day mark-ups in fixed income retail trades.[4] We acknowledged that either a price reference approach or mark-up approach based on PMP is an improvement over the *status quo*.[5] The Office of the Investor Advocate specifically endorsed a move to disclosure of a mark-up based upon PMP over a price reference approach, noting that the move to mark-up disclosure based upon PMP, among other things, reflects market conditions and has the potential to provide a more accurate benchmark for calculating transaction costs.[6]

Consistent with our earlier comments, the Office of the Investor Advocate continues to believe that investors would be poorly served by inconsistency between MSRB and the Financial Industry Regulatory Authority's ("FINRA") rules and guidance relating to confirmation disclosure.[7] We acknowledge the deliberative approach taken by the MSRB to harmonize the manner in which the PMP is determined for purposes of municipal securities with the FINRA guidance for determining the PMP for other fixed income securities.[8] In the interest of consistency between FINRA and the MSRB, the MSRB's proposal to adopt FINRA's PMP guidance appears reasonable. However, the context in which the PMP guidance would be applied will be expanded, raising significant concerns for fixed income investors as it relates to price disclosure.

FINRA's PMP guidance was originally adopted, and has been historically applied, only in the context of preventing mark-ups that are so excessive as to be deemed unethical. However, if PMP guidance is adopted for confirmation disclosure purposes as well, the same PMP guidance would be applied in a much different context – namely, as a disclosure of compensation paid to dealers by retail customers. Under this new context, precision and accuracy in the calculation of PMP becomes more important. Given the increased importance of calculating PMP, the Office of the Investor Advocate stresses the need for the MSRB to take a fresh look at the guidance. The MSRB should carefully scrutinize the guidance and its application to potential confirmation disclosure rules to prevent manipulation of the PMP calculation for confirmation disclosure purposes. We believe that misleading disclosure would be worse than no disclosure at all.

In particular, the Office of the Investor Advocate has a significant concern with how the PMP may be determined under the current guidance in circumstances involving non-arm's length affiliate transactions. We believe the guidance should seek to ensure that the PMP reflects the true market price and, in our view, there are several possible ways to accomplish this goal. The Office of the Investor Advocate urges the MSRB to consider addressing our concern before

---

[4] *See* Comment Letter, Rick. A. Fleming, Investor Advocate, SEC, *RE: MSRB Regulatory Notice 2015-16 Request for Comment on Draft rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers, RE: FINRA Regulatory Notice 15-36 Request for Comment on Revised Proposal Requiring Confirmation Disclosure of Pricing Information in Corporate and Agency Debt Securities Transactions* (Dec. 11, 2015), http://www.finra.org/sites/default/files/15-36_SEC_comment.pdf.

[5] *Id.*

[6] *Id.*

[7] Consistent MSRB and FINRA proposals and guidance would work in tandem to provide retail investors with better price transparency in corporate and municipal bond transactions. *Supra* note 4 at 2.

[8] *Id.* Modifications to the FINRA Guidance intended to tailor the determination of PMP to the municipal securities market are included in the proposed language of the MSRB's Request for Comment. *Id.*

filing a proposed rule change with the Commission. A more detailed discussion, along with several potential solutions, is set out below.

MSRB's Proposed Guidance on Prevailing Market Price

The MSRB Request for Comment proposes guidance for municipal securities dealers to determine the PMP of a municipal security. Specifically, the proposed guidance establishes a rebuttable presumption whereby the PMP is presumed to be the municipal securities dealer's contemporaneous cost (or proceeds).[9] This presumption is rebuttable in cases of change in interest rates, credit quality, or news.[10] To the extent the presumption is rebutted, or a dealer has no contemporaneous transaction, a hierarchy of pricing factors will be considered, in successive order.[11] These factors are: (i) contemporaneous interdealer prices; (ii) contemporaneous dealer transactions with certain institutional accounts; and (iii) if an actively traded security, contemporaneous quotations.[12] In the event the presumption is overcome, or inapplicable, and none of the hierarchy of pricing factors is applicable, the dealer is permitted to consider other factors including prices and yields from contemporaneous transactions in "similar" municipal securities.[13] Finally, if the dealer is unable to determine the PMP using any of the above factors, the municipal security dealer may consider economic models.[14]

The MSRB Request for Comment largely follows the existing FINRA guidance for calculating the PMP of other fixed income securities. The Request for Comment suggests that the proposed guidance on the PMP and calculating mark-ups and mark-downs for principal transactions in municipal securities "may promote consistent compliance by brokers, dealers and municipal securities dealers with their existing fair-pricing obligations under MSRB rules, in a manner that would be generally harmonized with the approach taken in other fixed income markets."[15] Further, the MSRB sought to balance the essential harmony between the municipal securities market and all other fixed income markets for purposes of determining PMP with the need to account for the unique characteristics of the municipal securities markets.[16]

The MSRB Request for Comment broadly asks whether the "generally harmonized approach and, particularly, whether the modifications are appropriate and whether additional modifications should be made" to account for the unique characteristics of the municipal securities market.[17] The MSRB Request for Comment also generally seeks comment on the

[9] *Id.* at 5-6, 17-18.
[10] *Id.* at 10, 17-18.
[11] *Id.* at 10, 18.
[12] *Id.*
[13] *Id.* at 10, 18-19. Factors used in determining the degree to which a municipal security is "similar" include: (i) credit quality considerations; (ii) the spread over U.S. Treasury securities; (iii) general structural characteristics and provisions; (iv) technical factors; and (v) tax treatment. *Id.* at 10, 20.
[14] *Id.* at 10, 19.
[15] *Id.* at 1 .
[16] *Id.* at 5. Some unique characteristics of the municipal securities market include "the large number of issuers and outstanding securities, the infrequency of trading in the secondary market, the differing tax rules and treatment, and the different credit structures, enhancements and redemption features that may not be applicable to or prevalent for other fixed income securities." *Id.*
[17] *Id.*

subjects of PMP and mark-up calculation, any competitive or anticompetitive effects, and efficiency and capital formation effects of the proposed guidance on market participants.[18]

Concerns Relating to Affiliate Transactions

The Office of the Investor Advocate supports efforts to augment price transparency and provide retail customers with useful, consistent, clear pricing information. The MSRB's guidance, when combined with mark-up disclosure, would be an important step forward in this regard. Unfortunately, the MSRB's proposed guidance may lend itself to loopholes and slippage when applied to transactions between affiliates, thereby resulting in misleading and inconsistent pricing disclosures to retail customers. More specifically, the Office of the Investor Advocate is concerned that there may be a loophole in non-arm's length affiliate transactions in the municipal securities market, which the Office believes needs to be resolved in the interest of fairness and consistency.

It is unclear whether the proposed guidance takes into account that, in a *non-arm's length transaction between affiliates*, the contemporaneous price resulting from the transaction is more likely to reflect a markup instead of the PMP. To illustrate this ambiguity, first, assume that 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, the following three transactions occur:

- First, Dealer A1 purchases Bond Y from an unaffiliated third-party for $90 ("Transaction 1");
    - Dealer A1 displays Bond Y for sale for $93 on Dealer A2's customer-facing platform;
    - During the day, no other dealers display any price for Bond Y.
    - Retail Customer sees Bond Y listed for $93 and places an order with Dealer A2 to purchase Bond Y at the displayed price;
- Second, Dealer A2 purchases Bond Y from Dealer A1 at $93 ("Transaction 2"); and
- Third, Dealer A2 sells Bond Y to Retail Customer for $93 + $1 trading fee.

In this scenario, under the MSRB's proposed guidance, it is possible that Dealer A2 may determine that the PMP would be $93 – the contemporaneous cost to Dealer A2 as evidenced by Transaction 2 between affiliates. Based on that determination, any mark-up disclosure provided to the retail customer would indicate that the customer had only paid $1 on the municipal securities transaction above the PMP. Instead, the Office of the Investor Advocate strongly believes that, in this scenario, Transaction 1 should determine the PMP. Dealer A2 should be required to look through Transaction 2, a non-arm's length transaction with Dealer A1, and use Transaction 1 in determining the PMP. Under such an approach, the PMP for the bond would be $90 and the affiliate transaction would not mask the overall cost paid by customer to the two affiliates of Company A.

[18] *Id.* at 14-15.

If transactions with affiliates are allowed to set the PMP, this practice could easily become the industry norm. This is particularly true if—as we hope—mark-up disclosure is later expanded to include *all* transactions with retail customers, not just same-day transactions. Should this legal structure become a reality for most brokerage firms, mark-up disclosure to retail customers may become meaningless and misleading. Essentially, rulemaking to increase post-trade price transparency through mark-up disclosure will have been for naught because every trade could show an identical mark-up of $1.

Importantly, we note that although the above example assumes a series of transactions that all occur on the same trading day, the Office of the Investor Advocate believes that requiring dealers to look through non-arm's length affiliate transactions should immediately extend beyond the one-day window, where appropriate. Specifically, the Office of the Investor Advocate believes that dealers should, absent strong supporting evidence, always be required to look through non-arm's length affiliate transactions for purposes of determining whether a mark-up is excessive, regardless of whether the affiliate transaction occurred on the same trading day.

In order to ensure a true and consistent pricing disclosure by all municipal securities dealers to all customers, the Office of the Investor Advocate encourages the MSRB to make clear that no such loophole exists for non-arm's length affiliate transactions. To do so, the Office of the Investor Advocate proposes three alternative solutions or a combination thereof. First, textual changes could be made to PMP guidance; second, adjustments could be made to a harmonized mark-up rule to be filed with the Commission; or third, clarification could be provided in the text of a Notice to the Commission. Each potential solution is discussed below.

Proposed Solutions

Textual Changes Clarifying PMP Guidance

The Office of the Investor Advocate believes that one possible solution[19] to prevent a loophole for non-arm's length affiliate transactions would be to make textual changes to the MSRB's proposed PMP guidance by clarifying the definition of "contemporaneous cost (proceeds)." The MSRB's proposed guidance currently states that "[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."[20] Under this current definition, it is possible that the customer-facing municipal securities dealer in the earlier illustration might improperly view Transaction 2 as its contemporaneous cost, and ultimately determine the PMP using that transaction.

To ensure that the proper transaction is used to calculate the dealer's costs, the current definition of contemporaneous cost (proceeds) could be enhanced to make clear that the concept applies to truly arm's-length transactions. Absent additional market information, the definition would require a dealer to look through affiliated transactions to determine its contemporaneous

[19] It is possible that other textual changes could achieve the same result, and we could support alternative proposals.
[20] *Id.* at 17.

cost (proceeds) and ultimately the PMP. In essence, the definition of contemporaneous cost (proceeds) cannot allow a dealer to ignore the cost incurred in a third-party, arms-length transaction in favor of the cost incurred in a subsequent affiliated transaction.

The Office of the Investor Advocate strongly supports efforts to create a uniform determination of PMP in all fixed income markets. Thus, it is important to note that any textual changes to the MSRB's proposed guidance may also require amendments to FINRA's relevant supplementary material, to the extent FINRA did not already believe its guidance prevented such exploitation.[21]

Adjustments to a Harmonized Mark-up Rule

In September 2015, the MSRB published MSRB Regulatory Notice 2015-16, Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers ("MSRB Regulatory Notice 2015-16").[22] In October 2015, FINRA sought comment on FINRA Regulatory Notice 15-36, Pricing Disclosure in the Fixed Income Markets ("FINRA Regulatory Notice 15-36").[23] In response to the MSRB's and FINRA's requests for comment, commenters, among other things, stressed the need for a coordinated and consistent approach to confirmation disclosure and some commenters expressed a need for additional guidance on PMP.[24]

Consistent with our comment in response to MSRB Regulatory Notice 2015-16 and FINRA Regulatory Notice 15-26, the Office of the Investor Advocate continues to maintain that investors would be poorly served by pricing disclosures that are different for corporate bonds as compared to municipal bonds.[25] The Office of the Investor Advocate believes that to avoid investor confusion, it is important for FINRA and the MSRB to adopt rules and guidance related to pricing disclosure that are consistent. We also continue to maintain that combining the MSRB's mark-up disclosure methodology with FINRA's same day window would best serve the interest of investors.[26] Such an approach would provide the MSRB and FINRA an opportunity to jointly address the loophole in non-arm's length affiliate transactions directly in their harmonized mark-up rules before filing their final rule proposal notices with the Commission.

---

[21] In order to achieve a harmonized approach to determining PMP with the MSRB, FINRA would need to amend Supplementary Material .01 Mark-Up Policy and/or Supplementary Material .02 Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities.

[22] MSRB, Regulatory Notice 2015-16, *Request for Comment on Draft rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transaction with Retail Customers* (Sept. 24, 2015), http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2015-16.ashx?n=1.

[23] FINRA, Regulatory Notice 15-36, *Pricing Disclosure in the Fixed Income Markets* (Oct. 2015), http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-36.pdf.

[24] *Supra* note 2 at 3; *See* FINRA, Comment Letters, Regulatory Notice 15-36, *Pricing Disclosure in the Fixed Income Markets*, http://www.finra.org/industry/notices/15-36; MSRB, Comment Letters, Regulatory Notice 2015-16, *Request for Comment on Draft rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transaction with Retail Customers*, http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2015/2015-16.aspx?c=1.

[25] *Supra* note 4.

[26] *Id.*

MSRB Regulatory Notice 2015-16 proposes to define the term "inventory-affiliate model" to mean "a business model in which the dealer, *on an exclusive basis*, acquires municipal securities from or sells municipal securities to an affiliate dealer that holds inventory in municipal securities and transacts with other market participants." Municipal securities dealers that use this inventory-affiliate model would be required to look through the transaction with the affiliate dealer and substitute the affiliate's trade with the outside party to determine whether mark-up disclosure would be required. According to MSRB Regulatory Notice 2015-16, this ensures "that the disclosed mark-up is a more accurate indication of the compensation paid by the customer when affiliated dealers effectively function as a single entity for purposes of executing the retail customer's transaction."[27] We agree. However, such rationale should be applied regardless of whether a dealer transacts with an affiliate on an exclusive or non-exclusive basis.

To be clear, the Office of the Investor Advocate supports the inclusion of "inventory-affiliate model" language in the final harmonized proposal and believes that certain textual changes to the definition of this term could adequately address its concerns relating to non-arm's length affiliate transactions. However, we believe that the term "inventory-affiliate model" should not be limited to business models in which dealers, on an exclusive basis, acquire or sell municipal securities to an affiliate. Instead, the Office of the Investor Advocate strongly encourages the MSRB and FINRA to expand the meaning of the term inventory-affiliate model to include business models in which the dealer, on an exclusive or non-exclusive basis, acquires or sells securities to an affiliate dealer that holds inventory and transacts with other market participants.

The impact and importance of applying an expanded definition is evident when put into context using our earlier illustration. Dealer A1 and Dealer A2 do not transact on an exclusive basis. Accordingly, under the narrow definition set out in MSRB Regulatory Notice 2015-16, Dealer A2 would not be required to look through its transaction with Dealer A1 to Dealer A1's transaction with a third party to determine whether mark-up disclosure would be required. On the other hand, if a broader definition of inventory-affiliate model were implemented, Dealer A2 would be required to look through its transaction with Dealer A1 and substitute Dealer A1's transaction with a third party. An expanded definition of the term inventory-affiliate model to include municipal securities dealers transacting on any basis with an affiliate dealer effectively closes the loophole for non-arm's length affiliate transactions by requiring all affiliate dealers to comply with a look-through requirement.

Adjusting the harmonized mark-up rule would, similar to making the suggested textual changes to the proposed PMP guidance, reduce the potential for market gaming. Beneficially, choosing to make necessary adjustments to a harmonized mark-up rule could eliminate the need for FINRA to take separate regulatory action, as would be required to harmonize PMP guidance if the MSRB made the suggested textual changes to its proposed guidance.

The Office of the Investor Advocate believes that making necessary adjustments to a harmonized mark-up rule provides a direct and efficient path forward for purposes of

[27] *Supra* note 22 at 10-11.

determining the PMP without creating unnecessary regulatory burdens or substantially slowing the progress towards adoption of harmonized fixed income confirmation disclosure regulation. However, while it would address the shortcomings of the PMP guidance for purposes of mark-up disclosure, it would not solve the previously described loophole for purposes of excessive mark-ups. We are concerned that the existing PMP guidance could still allow a dealer to use affiliated transactions to establish a higher PMP and avoid liability for excessive markups. We would encourage you to further consider that issue.

Clarification in Notice

In the final alternative, the loophole in non-arm's length affiliate transactions could be addressed by including a description in the Notice for MSRB's proposed guidance regarding how the MSRB would expect a dealer to calculate its contemporaneous costs under such circumstances. The MSRB could provide an example demonstrating that, under the proposed definition, dealers will likely need to look through non-arm's length transactions with affiliates and instead determine the contemporaneous cost (and likely the PMP) using the third-party transaction. Should the MSRB's proposed rule change be approved by the Commission, the Commission would publish an order granting approval of the MSRB's proposed rule change and we would expect that the Commission would make note of the clarification provided by the MSRB and rely on that example in finding the proposal to be consistent with the Exchange Act.

While this could achieve a similar result to the two previous proposed solutions, the Office of the Investor Advocate believes this is the least desirable approach. An example alone may not carry the same legal authority as the textual rule, and a clarification contained only in the Notice is not the best resource for interpreting and understanding ambiguous rule text.

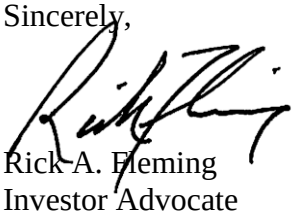
Conclusion

The Office of the Investor Advocate recognizes the MSRB's action in response to commenters' strong desires for a coordinated and consistent approach to confirmation disclosure in fixed income securities markets and their responsiveness to commenters' call for additional guidance on prevailing market price to support a possible mark-up disclosure. The Office of the Investor Advocate applauds the MSRB's efforts to enhance bond market price transparency and to provide investors and other market participants with useful, clear, and consistent guidance.

While the Office of the Investor Advocate regards the MSRB's proposed guidance on the determination of PMP as generally useful, clear, and consistent with FINRA's, we believe that a potential loophole exists for non-arm's length affiliate transactions, which may cause misleading and inconsistent pricing disclosures to investors. The Office of the Investor Advocate advises the MSRB to close the loophole in the interest of fairness and consistency in the fixed income securities markets. Although any of the proposed solutions would be helpful, the Office of the Investor Advocate believes that a combination of guidance and rule text would be the most effective solution.

Thank you, again, for the opportunity to submit our comments regarding this important guidance. Should you have any questions, please do not hesitate to contact me or Senior Counsel Ashlee E. Connett at (202) 551-3302.

Sincerely,



Rick A. Fleming
Investor Advocate

cc (electronically): Lynnette Kelly, MSRB, Executive Director
Michael L. Post, MSRB, General Counsel – Regulatory Affairs
Margaret Blake, MSRB, Associate General Counsel
Saliha Olgun, MSRB, Assistant General Counsel
Robert Colby, FINRA, Executive Vice President and Chief Legal Officer
Patrick Geraghty, FINRA, Vice President, Market Regulation