THE BOND BUYER
Thursday, September 22, 2016 | as of 4:35 PM ET

Securities Law

Why Dealers Are Struggling with Proposed Markup Disclosure

By Jack Casey
September 22, 2016

LOS ANGELES – Dealers are struggling with how to comply with the Municipal Securities Rulemaking Board's proposed markup disclosure requirements and whether they can create computer programs or rely on pricing services for compliance.

Their struggle was evident from panel discussions at The Bond Buyer's California Public Finance Conference here.

Peg Henry, deputy general counsel for Stifel and former general counsel at the MSRB who moderated a panel on regulation, said the MSRB's proposed prevailing market price guidance will prove problematic for dealers trying to create a computer program to comply with the requirements.

The MSRB filed rule changes with the Securities and Exchange Commission earlier this month that would require a dealer, which buys or sells munis for or from its own account to a retail customer and engages in one or more offsetting transactions on the same trading day in the same security, to disclose its markup or markdown in the confirmation they send the customer.

The rule filing contains guidance for dealers on how to establish the prevailing market price of a municipal security in order to calculate their compensation – the markup or markdown.

The guidance establishes a waterfall of factors for dealers to consider when determining the prevailing market price. They would initially look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of prevailing market price. They would then make a series of successive other considerations if that data is not available. They can look at contemporaneous trades of the muni in interdealer trades, then trades of the muni between other dealers and institutional investors, then trades on alternative trading systems or other electronic platforms.

The bottom of the waterfall allows dealers to use prices or yields derived from economic models.

But dealers have told the MSRB that it would be difficult or impossible to establish computer models to go through the waterfall of factors.

During the session, Henry asked Robert Fippinger, the MSRB's chief legal counsel, if third party pricing services could qualify under the rule as economic models.

Fippinger said, "In the description of the economic model, I think the words … at least suggest without saying that the economic model could be developed by somebody outside the firm."

But he added that if a dealer chooses to use an outside pricing service, it would be in effect endorsing that service's analysis as comparable to the economic model envisioned by the guidance. He said he is not sure if pricing services would be able to rise to the level of economic models.

Meanwhile, Mary Simpkins, senior special counsel with the SEC's Office of Municipal Securities who was on that same panel, said OMS is exploring possible regulatory solutions that could address whether issuers should in some way be required to disclose information about their bank loans and privately placed securities. Issuers so far have only been encouraged to voluntarily disclose these financings.

The MSRB circulated a concept release earlier this year that asked whether it should require municipal advisors to disclose information about their issuer client's bank loans or privately placed municipal securities.

While the idea gained some traction, the majority of those who responded said they thought it would be a better idea to have the SEC address such a requirement in amendments to 15c2-12.

Participants on a panel on direct purchases on Thursday agreed that 15c2-12 would be an effective way to address bank loan disclosure.

Scott Nagelson, managing director and head of US Bank's Government Infrastructure Group, said he thinks an amendment to the rule "would be healthy."

"Standardizing [disclosure] would be a positive for all parties," he said. "I think we need to go ahead and do that and stop talking about it."

Rudy Salo, a partner with Nixon Peabody, also said that such a change "probably is the best fix" as it would keep small issuers who may only have one private placement in recent years from having to take on an unnecessarily large disclosure burden and keeping all issuers focused on the importance of ongoing disclosure.

Lawyers, regulators, and market participants on other panels also talked about how regulators could best address compliance questions and concerns from the market on disclosure and other issues.

Dave Sanchez, senior counsel with Norton Rose Fulbright and a former lawyer with the SEC's OMS who was on a second panel on regulation, said it was clear from the first panel that regulators' focus moving forward is "much more granular" and centered on issues included in the SEC's 2012 report on the municipal market.

"The 2012 SEC report laid out in broad categories what the SEC wanted to work on and I think a lot of what has happened since then and a lot of what is on the horizon is merely execution of that," Sanchez said.

He also said "the real big trick" moving forward for regulators within the SEC, MSRB, and Financial Industry Regulatory Authority is making sure there is consistency in the examination of dealers and municipal advisors and the enforcement of existing regulations.

"The coordination needs to increase five to tenfold," he said. "I think folks that have experienced examinations … see a disconnect in what they hear from policymakers and what they experience on the ground."

Additionally, he said, market participants need to realize that when responding to the SEC with comments and suggestions, their tendency to always put "their thumb on the scale" in insisting on their view can paralyze the commission from getting anything done and that a more effective approach would be to go for "80% of what they want instead of 110%."

On the other side, he noted that regulators have a tendency to pursue "easy rules for them to hit someone with a violation" and that there needs to be "a little bit of relaxing on that point."

One main issue for the market discussed during both panels was possible improvements to disclosure, including potential changes to the SEC's Rule 15c2-12. Several market groups have recently asked the SEC to explore such changes or additional guidance. The rule was adopted for primary market disclosure in 1989 and then amended in 1994 to cover secondary market disclosure. It was amended again in May 2010, mostly adding and clarifying existing material event notices.

The Securities Industry and Financial Markets Association shared a white paper with the SEC in April that listed a number of proposed changes, including giving municipal advisors some continuing disclosure responsibilities. The National Federation of Municipal Analysts sent a letter in August asking the commission to review 15c2-12 with an eye toward establishing more standardization in terms of the form, content, and timing of the information the rule requires to be disclosed.

Panelists briefly discussed SIFMA's idea for giving MAs some continuing disclosure responsibilities.

Leslie Norwood, managing director and co-head of municipal securities for SIFMA, explained that the white paper suggested that the SEC create an amendment to the rule or issue guidance that would raise the duty of municipal advisors and make them responsible for checking statements and offering documents on competitive transactions when an MA is engaged by an issuer in preparing an official statement.

MSRB Rule G-42 on core duties of municipal advisors states that MAs have a duty of care with respect to the information they provide in preparation of an official statement and Norwood said that could be the basis for the change.

Sanchez, who was joined on his later panel by PFM's chief compliance officer Leo Karwejna, emphasized the importance of interpretive guidance both on disclosure questions and others facing the market instead of new rules or undertakings that some view as giving more certainty.

"People always want certainty in the market," he said. "It's not going to happen. Across the board, you're not going to have that level of certainty you want [and] honestly, that's okay."

He added that "the great thing about interpretive guidance … is [it is] actually not binding."

"If you don't agree … you have the ability to act differently," he said. "At the same time, they give you more detail and more comfort on how you act on a day-to-day basis, which is what the market wants."

Karwejna said he considers guidance "to be the most important thing [regulators] could do."

"Interpretive guidance [and] staff guidance within the SEC is still a lift," Sanchez said. "But it is much less of a lift than a full-blown rule."

Both he and Karwejna suggested the SEC address disclosure through such updated guidance.

"I think they should focus on the practical elements of clearly delineating who is responsible for what," Karwejna said, referring to the issuers, MAs, underwriters, and others who participate in disclosure.

Sanchez added that the SEC should work to "really push through interpretive guidance that addresses all of these questions from [the standpoint of] each participant" rather than "continue to jury-rig rules through 15c2-12 or put Rule G-42 to partially apply to antifraud, which just really confuses the market and doesn't solve [the] main issue which is to have better disclosure."

Underwriters have "very legitimate questions" about their roles and the differences that arise between competitive and negotiated sales, he said. It would also be helpful to have written guidance from the commission that confirms that MAs' responsibilities depend on their scope of services, Sanchez added.

Karwejna said he sees the real challenge for the SEC on 15c2-12 as considering what interests are really being protected and how it wants to make sure the rule is doing that.

"That to me doesn't mean changing so that issuers have … to be directly regulated," he said.

Sanchez responded by saying direct regulation "could be extremely simple" like the commission saying "issuers, you are required to do a contract that has these 15 things."

"You [would] actually still preserve your gatekeeper role for broker-dealers because broker-dealers have the due diligence obligation anyway," Sanchez said. "I think by letting underwriters affirmatively off the hook but putting a soft, not complicated, not paper-heavy requirement on issuers would get you where you need to go because in order to accomplish the transaction, you still have all these gatekeepers that are required to look at [the] documents."
