



Municipal Bonds: What You Need to Know about MSRB Rule Changes

The muni bond market faces a significant regulatory change in the coming year, adding yet another reason to consider professional management.

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IN BRIEF

- We've identified four reasons why investors may find it beneficial to use a professional muni-bond manager: **credit research capabilities, potential pricing advantages, market access, and a disciplined investment approach in volatile markets.**
- But now, we believe there's a fifth, equally compelling reason: **pending rule changes related to muni-bond pricing** from an industry regulator scheduled for May 2018.
- The first change: trade confirmations provided to retail clients by brokerage firms must **disclose an estimate of the amount of any bond markup or markdown** using reasonable diligence on certain principal transactions.
- Second, disclosure statements on retail trade confirmations must **provide links to a Municipal Securities Rulemaking Board (MSRB) site** containing publicly available trade data.
- Finally, the MSRB has provided guidance in **determining the prevailing market price** of muni bonds, a potentially challenging exercise for dealers in municipal bonds.
- These changes are meant to provide **greater transparency on pricing** for retail buyers of muni bonds. Here we provide more details, including information on certain exceptions.
- **The key takeaway:** Challenges from these changes may lead advisors and their clients to consider using an **experienced active manager with a range of muni-bond strategies.**

In a recent *Market View*, we covered [four reasons why financial advisors and their clients have considered using a professional asset manager](#) to manage client municipal bond portfolios:

1. Following the 2008–09 financial crisis, the number of 'AAA' rated municipal bonds has dipped, making in-depth credit analysis more important than ever.
2. Individuals stand to benefit from professional managers' institutional pricing advantage, as they are able to purchase large blocks of bonds at wholesale, rather than retail prices.
3. Municipal dealer inventory levels have fallen roughly 60% since 2006, making it more difficult to find bonds.
4. A professional manager with deep experience in various market environments and a focus on long-term investing can avoid the pitfalls of trying to time the market in reaction to negative headlines.

These four points have caused many advisors and their clients to consider entrusting their bonds to institutions that employ experienced and dedicated credit research analysts, place large trades with an extensive list of dealers with whom they maintain close relationships, and remain invested throughout market cycles.

[Note: Employment of active management techniques and strategies in managing investment portfolios does not guarantee outperformance versus passively managed strategies based on similar asset classes and investment factors.]

New regulation has added yet another reason to this list. Advisors are being diverted from their efforts to gather assets, build their businesses, and focus their attention on client portfolios, in order to understand and comply with new rules issued by government and industry regulators. In particular, amendments to two rules related to municipal-bond pricing from the Municipal Securities Rulemaking Board (MSRB) have prompted many advisors to begin conversations with their retail clients about shifting their individual municipal bond holdings to dedicated accounts with money managers, like Lord Abbett. On November 17, 2016, the board received approval from the Securities and Exchange Commission for a proposed rule change to MSRB Rule G-15 ("Confirmation, Clearance, Settlement, and Other Uniform Practice Requirements with Respect to Transactions with Customers") and MSRB Rule G-30 ("Prices and Commission"). Below, we provide a detailed overview of the amendments that are scheduled to become effective May 14, 2018. Here's a quick summary:

- Trade confirmations provided to retail clients by brokerage firms must disclose an estimate of the amount of any bond markup or markdown based upon reasonable diligence, allowing retail clients to clearly distinguish between the portion of the bond's purchase or sale price that represents the prevailing market price, and the portion that represents compensation to the brokerage firm.
- The confirmation should include a reference and hyperlink (for electronic statements) to the MSRB Electronic Municipal Market Access (EMMA) webpage that contains publicly available trade data on the subject security, giving clients information on the market for the bond at the time of execution.
- The MSRB will provide guidance to dealers on determining prevailing market price for the purpose of calculating markups, among other determinations

MUNICIPAL BOND MARKET EVOLUTION

Before diving into details on the rule amendments, we believe it is important for market participants to understand how the municipal bond market has evolved to this point, especially with regard to the MSRB's ongoing efforts to increase price transparency. Prior to the late 1990s, there were some services providing pricing information about new bond issues to the public. However, price transparency was lacking in secondary market trading, given the fact that municipal-bond trades were not disclosed to the public. Market participants only knew about trades if they performed the transactions themselves, or if dealers contacted them with market updates. During the late 1990s, the MSRB required dealers to report trades within 15 minutes of occurrence. This information became available electronically, but early on, the actual size of the trade was not disclosed until one week after trades occurred.

Over time, the MSRB upgraded its website, and other services, such as Bloomberg, making trade information easier to find and allowing market participants to follow market activity more closely. Still, while institutional participants were able to successfully parse the data, retail investors who were only part-time participants were more challenged to find the trading information that could help them understand their investments. In order to make the market fairer for retail investors, the MSRB consistently has been improving the flow of data, while attempting to develop rules to increase price transparency and make trading activity easier to follow. Thus, the new disclosure rules.

WHAT IS THE MARKUP DISCLOSURE RULE?

The amendment to Rule G-15 requires dealers to disclose markups and markdowns to retail (non-institutional¹) customers on certain principal transactions on the customer's confirmation. In other words, when a dealer purchases a bond in the market, puts it in its inventory, and sells that bond to a retail client on the same day it made the purchase, they must disclose to the client what

they paid for the bond if the timing was contemporaneous, and estimate how much compensation they will earn. More specifically, a markup/down disclosure is required when executing principal transactions in which the dealer purchases or sells the security in one or more offsetting transactions that meet or exceed the size of the retail customer's trade, in aggregate. To reiterate, the offsetting transaction must occur on the same day as the retail customer's trade for the disclosure requirement to be triggered. The MSRB has offered an example that provides more clarity:

"For example, if a dealer purchased 100 bonds at 9:30 a.m., and then executed three customer buy orders for 50 bonds each in the same security on the same day without purchasing any more of the bonds, the proposed rule change would require markup disclosure on two of the three trades, 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."

Technically, a dealer could hold bonds overnight to avoid triggering disclosure; however, the MSRB has made it clear that structuring trades to avoid disclosure requirements would be an unfair practice in violation of MSRB Rule G-17. Note that if the offsetting transaction was done with an affiliate of the dealer and that it was not considered to be at "arm's-length,"² the dealer is required to "look through" the transaction with the affiliate and determine whether the disclosure requirement is triggered based on the time and terms of the affiliate's transaction with third parties.

The following qualify as exceptions to the disclosure requirement:

- If the same-day offsetting principal transaction executed by the dealer was executed by a trading desk that is deemed "functionally separate" from the trading desk that executed the retail customer transaction and the separate trading desk had no knowledge of the retail customer transaction.
- If the transaction was done as a "list-offering price" transaction. This is defined by the MSRB as "a primary market sale transaction executed on the first day of trading of a new issue by a sole underwriter, syndicate manager, syndicate member, selling group member or distribution participant to a customer at the published list offering price for the security."³
- If the customer's transaction is for the purchase or sale of municipal fund securities.

In addition to the markup/markdown disclosure requirements, the MSRB also added language to the required disclosure statements to be displayed on confirmations. The language explained that the confirmation should include a reference and hyperlink (for electronic statements) to the MSRB Electronic Municipal Market Access webpage that contains publicly available trade

data on the subject security, along with a description of the type of information on the page. This is intended to give clients a sense of the market for the security transacted at the time of execution.

In short, once the rule is implemented, retail clients will be able to clearly distinguish between the portion of their bond's price that represents the prevailing market price and the portion that represents compensation to the brokerage firm. According to the MSRB, "requiring dealers to disclose their markups on retail customer confirmations would provide meaningful and useful pricing information to retail investors and may result in lower transaction costs for such investors." This means that this rule is being adopted to make sure that retail investors receive fair and appropriate pricing.

DEALER'S RESPONSIBILITY IN DETERMINING THE PREVAILING MARKET PRICE

The amendment to Rule G-30 ("Supplementary Material .06") provides guidance to dealers on determining prevailing market price for the purpose of calculating markups, among other determinations. The prevailing market price is determined by referring to the dealer's contemporaneous cost/proceeds. According to the MSRB, a dealer's cost (proceeds) is 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.

There are certain bases when it can be determined that contemporaneous cost may not be equal to prevailing market price:

- If interest rates or credit quality have changed enough that it would result in a change in the security's price between the time of the dealer's purchase into inventory and sale to the client.
- If news were to be released on the issue that would impact the security's price between the time of the dealer's purchase into inventory and sale to the client.

If it's determined that the dealer's cost is not contemporaneous because the purchase was not made close enough in time to the customer transaction, or it was executed in close enough time, but that any of the scenarios outlined above have occurred, a dealer can refer to other forms of pricing information to determine prevailing market price.⁴ This information includes the price of any contemporaneous inter-dealer transactions in the subject security, the price of a transaction between the dealer and an institution with which any dealer regularly transacts with in the subject security, or the contemporaneous bid (offer) on an inter-dealer system in the subject security, if the security is actively traded and transactions generally occur at the displayed quotations. It is important to note that the alternative forms of pricing information must be referred to in the order listed above. If the factors above

are unavailable due to lack of trading in the security, dealers will need to consult additional factors—using the prices of securities deemed to be "similar" or econometric pricing models. Note that the dealer's responsibility when determining prevailing market price extends beyond just trades that trigger the markup disclosure.

CONCLUSION

While regulations have changed, the municipal bond market has not. The muni sector recently has offered high-quality securities producing attractive tax-exempt income for investors. *[Although, due to market volatility, these conditions may not continue in the future.]* With this in mind, many advisors may wish to continue investing a portion of their clients' capital in this asset class where appropriate, but reevaluate their means of gaining the exposure. Some dealers might respond by doing fewer individual bond trades, and turn more accounts over to active professional managers with greater operational and analytical resources and access to a fuller range of bonds. They might prefer to have their client pay a management fee on their assets under management rather than have to deal with understanding and implementing the markup/markdown and price-determination requirements. Over the next year, while dealers are preparing to comply with this new rule, these crucial decisions will need to be made.

In that regard, it's worth remembering that Lord Abbett has been managing municipal portfolios since the early 1980s. We offer a full range of mutual fund products across the maturity and credit quality spectrums. In addition, we offer an extensive suite of separately managed account strategies managed to produce attractive total return using rigorous yield-curve analysis to target optimal maturities. Finally, we offer a selection of municipal ladders managed to produce a potential tax-free income stream with a defined maturity structure that may protect against rising rates. ■

¹A non-institutional customer is a customer with an account that is not an institutional account, as defined in Rule G-8(A)(XI). New Rule G-15 (a)(vi)(J).

²For purposes of the rule change, the MSRB considers an "arms-length transaction" to be one that was conducted through a competitive process in which non-affiliate dealers could also participate. New Rule G-15 (a)(vi)(I).

³Rule G-14 RTRS Procedures (d)(vii) "List Offering Price/Takedown Transaction" means a primary market sale transaction executed on the first day of trading of a new issue:(A) by a sole underwriter, syndicate manager, syndicate member, selling group member, or distribution participant to a customer at the published list offering price for the security ("List Offering Price Transaction").

⁴Rule G-30 Supplementary Material .06 (a)(v)(A) Prices of any contemporaneous inter-dealer transactions in the municipal security in question; (B) In the absence of transactions described in (A), prices of contemporaneous dealer purchases (sales) in the municipal security in question from (to) institutional accounts with which any dealer regularly effects transactions in the same municipal security; or (C) In the absence of transactions described in (A) and (B), for actively traded municipal securities, contemporaneous bid (offer) quotations for the municipal security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

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