

Client Alert

Current Issues Relevant to Our Clients

May 15, 2014

New MSRB Fair-Pricing Rule Effective July 7, 2014

The Municipal Securities Rulemaking Board (the “MSRB”) recently announced the approval and effectiveness of its new fair-pricing rule. Amended MSRB Rule G-30 consolidates dealer fair-pricing obligations into a single rule on prices and commissions for principal and agency transactions in municipal securities. The new rule is effective on July 7, 2014. The new rule and Supplementary Material seeks to preserve the substance of current fair-pricing requirements under multiple existing rules and interpretive guidance. The MSRB notice is available [here](#).

Background

The MSRB municipal security fair-pricing obligations for broker-dealers currently fall under MSRB Rules G-18 and G-30 as well as various interpretive notices and interpretive letters under those and other rules. In an effort to ease the burden of understanding and complying with fair-pricing requirements, the MSRB is now consolidating the current rules and guidance into a single revised Rule G-30 governing fair-pricing. The MSRB rule change codifies and supersedes existing interpretive guidance and also deletes current Rule G-18. The MSRB has stated that revised Rule G-30 preserves the substance of dealers’ existing fair-pricing obligations.

Basic Rule G-30 Obligations

Rule G-30 imposes separate obligations depending on whether a dealer is acting as principal for its own account in a transaction with a customer or as agent on behalf of a customer. Under MSRB rules, the term “customer” generally means any person other than (1) another broker, dealer or municipal securities dealer or (2) an issuer in transactions involving the sale by the issuer of a new issue of its securities. With respect to principal transactions, Rule G-30 provides that no broker, dealer or municipal securities dealer (collectively, a “dealer”) may purchase municipal securities for its own account from a customer, or sell municipal securities for its own account to a customer, except at an aggregate price that is “fair and reasonable” (including any mark-up or mark-down). Under the new rule, dealer compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction. As part of the aggregate price to the customer, mark-up or

mark-down also must be a fair and reasonable amount, taking into account all relevant factors.

With respect to agency transactions, Rule G-30 requires that a dealer must make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions when executing a transaction for or on behalf of a customer as agent. The rule further prohibits dealers from purchasing or selling municipal securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount. Supplementary Material requires that a dealer effecting an agency transaction must exercise the same level of care as it would if acting for its own account.

Dealers Must Exercise “Diligence” in Assessing a Security’s Market Value and Reasonableness of Compensation

Whether a dealer acts as principal or agent, Supplementary Material to the rule requires that in all transactions a dealer must exercise diligence in establishing the market value of a security and the reasonableness of the compensation received on the transaction. The Supplementary Material further provides that a “fair and reasonable” price bears a reasonable relationship to the prevailing market price of the security. The Supplementary Material also notes that the lack of a well-defined and active market for a security does not eliminate the need for diligence in determining the market value as accurately as reasonably possible in satisfying fair-pricing obligations. The Supplementary Material also notes that a dealer may be required to use greater efforts to establish a security’s value when the dealer is unfamiliar with a security. The Supplementary Material also states that a bid-wanted procedure is not always a

conclusive determination of market value. Effectively, the Supplementary Material provides that a dealer may need to check the results of a bid-wanted process against other objective data to fulfill its fair-pricing obligations, particularly when the market value of an issue is unknown.

Fair-Pricing vs. Reasonable Compensation

The new rule's Supplementary Material distinguishes "reasonable compensation" from "fair-pricing." For example, a dealer could restrict its profit on a transaction to a reasonable level (reasonable compensation) and still violate the rule if the dealer fails to adequately assess the market value of a security and, as a result, pays a price well above market value. The Supplementary Material notes that it would be a violation of fair-pricing responsibilities if the dealer passed this price on to a customer even if the dealer made little or no profit on the trade (i.e., the dealer compensation was reasonable). The Supplementary Material sets forth a list of factors to be considered for both "reasonable compensation" and "fair-pricing" determinations.

Fair and Reasonable Price to Customer. The new Supplementary Material sets forth a list of relevant factors to be used in determining whether a customer's price is "fair and reasonable." This list states that the most important factor is determining whether the yield is comparable to that of other securities of comparable quality, maturity, coupon rate, and block size then available in the market. Other factors include: (i) the best judgment of the dealer concerning the current fair market value of the securities; (ii) expense involved in effecting the transaction; (iii) that the dealer is entitled to a profit; (iv) total dollar amount of the transaction; (v) service provided in effecting the transaction; (vi) availability of the securities in the market; (vii) the rating and call features of the security (including the possibility that a call feature may not be exercised); (viii) the maturity of the security; (ix) the nature of the dealer's business; and (x) the existence of material information about a security available through the MSRB's Electronic Municipal Market Access ("EMMA") or other established industry sources.

Fair and Reasonable Compensation—Commissions and Service Charges. The Supplementary Material provides that a variety of factors can affect the determination of whether a commission or service charge is "fair and reasonable" under the rule. These factors may include: (i) the availability of the securities; (ii) the expense of executing or filling the customer's order; (iii) the value of the services rendered; (iv) the amount of any other compensation received or to be received by the dealer in connection with the transaction; (v) that the dealer is entitled to a profit; (vi) the total dollar amount and price of

the transaction; (vii) the best judgment of the dealer concerning the fair market value of the securities when the transaction occurs; and (viii) for municipal fund securities (such as 529 plans), whether the dealer's commissions or other fees fall within the sales charge schedule specified in NASD Rule 2830.

Superseded Guidance

The new rule and Supplementary Material supersede the following interpretive notices and letter in their entirety: Review of Dealer Pricing Responsibilities (Jan. 26, 2004); Republication of September 1980, Report on Pricing (Oct. 3, 1984); Interpretive Notice on Pricing of Callable Securities (Aug. 10, 1979); and MSRB Interpretive Letter—Factors in Pricing (Nov. 29, 1993). To the extent that those interpretive materials address topics other than fair-pricing or do not conflict with other MSRB rules or interpretations, they will remain in effect at this point.

FINRA Rule Proposal

MSRB Rule G-30 only applies to transactions in municipal securities. The Financial Industry Regulatory Authority, Inc. ("FINRA") has also proposed rule changes related to fair-pricing, markups, markdowns and commissions. The FINRA proposal would consolidate fair-pricing obligations under its rules into new FINRA Rule 2121, replacing NASD Rule 2440 and related interpretive materials. FINRA originally proposed significant changes to the substance of NASD Rule 2440 as part of the consolidation (see our February 5, 2013 Client Alert available [here](#)). After encountering somewhat significant debate related to the proposed changes, FINRA has instead decided to move forward with a consolidated rule proposal that merely moves NASD Rule 2440 and its Interpretive Materials to new FINRA Rule 2121 without substantive changes and will defer proposing any substantive changes to the rule to a future rule proposal. FINRA filed its proposal with the Securities and Exchange Commission ("SEC") on May 9, 2014. FINRA filed the rule for immediate effectiveness but has not yet set an effective date. FINRA's filing with the SEC is available [here](#).

While new MSRB Rule G-30 and the FINRA rules address the same concepts, the two rule regimes will continue to differ in various substantive respects. For example, the FINRA rule will continue to include Supplementary Material that addresses what is known as the "5% Policy" related to mark-ups on securities transactions, but MSRB Rule G-30 does not include such a policy. As a result, FINRA members that are also MSRB registrants that conduct transactions in both municipal securities as well as non-municipal securities should consider the distinctions in rules when assessing compliance policies

and business practices. For additional information, please refer to our February 2013 Client Alert linked above.

For More Information

To discuss any topic covered here, please contact any member of the Investment Management Group or visit us at chapman.com.

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