

SECTION 4: MUNICIPAL MARKET RULES

4a. MSRB RULE G-13, QUOTATIONS

Rule G-13 applies to all municipal quotations distributed by any means of communication, e.g., through Bloomberg, Munifacts, newspaper, telephone, etc. The rule states that all quotes, including "bids" and "offers," and "bids wanted" and "offers wanted:"

Bona Fide Quotes

Must be "bona fide;" however all quotes are always subject to prior purchase or sale and to subsequent change in price.

Quotes Reflect Fair Market Value

Must be priced to reflect the dealer's best judgment of the fair market value of the securities.

Regarding the meaning of "bona-fide," this is defined as the quote being "firm" unless otherwise stated, with the dealer being willing to buy or sell the quoted security at the quoted price and in the amount specified. Failure to honor a bona-fide quote is a rule violation under Rule G-17 (covered next), known in the industry as "backing away."

Regarding the exception provided for the "bona-fide" quote being subject to prior sale and/or change in price, if either of these events occur, the dealer is obligated to update or withdraw the quote on a timely basis. A "stale" or invalid quote violates the rule.

Basis For Determining Fair Market Value

All quotes must represent prices that are determined using the dealer's best judgment of the fair market value at the time of the quote. The rule does not require that the quotation represent **the** fair market value (this is an impossible determination in the illiquid municipal marketplace). Instead, the quote must have a "reasonable relationship" to the fair market value, taking into account all relevant factors, including:

The firm's overall inventory position;

The firm's inventory position in that security;

The firm's anticipation of the direction of the movement of the market for the securities; and

The firm's knowledge of facts about the issuer (such as the fact that the security has been called; or that the issuer has announced a default).

The rule prohibits the pulling of quotes "out of thin air." There must be a "reasonable basis" for determining the fair market value quoted.

**Security Does
Not Have To Be
Owned To Be Quoted**

A municipal firm is permitted to quote a security that it does not own under this rule, as long as the firm is prepared to sell that security at the stated price. If the firm knows that the security is not available in the market, then giving that quote would be prohibited.

Bids wanted ("BW") and offers wanted ("OW") are acceptable quotes, as are nominal and subject quotes. They must, however, be properly identified as such.

Nominal Quote

A "nominal" quote is a quote given for informational purposes only - the dealer is clearly stating that he or she is **not** willing to trade at those prices.

For example a municipal "workable" is a type of nominal quote. Assume that a firm wants to sell some bonds, and starts "shopping the market" for bids. The first dealer called says: "I think I might buy them at about a 5.00 basis." This is known as a "workable" - the dealer called is given a likely price at which he might buy the bonds - but this is not firm. It is solely informational. The selling firm will continue to "shop" until it finds the best "workable." Then, it will go back to that dealer to nail down a firm bid for the bonds.

Subject Quote

A "subject" quote is one which is subject to some condition, this condition usually being that the quote has to be re-verified (and the price may, hence, be subject to change) before a trade can occur.

**Joint Accounts May
Only Publish One
Quote**

If a municipal dealer participates in a secondary market joint account (this is where a group of dealers join together to market a large block of bonds in the secondary market), multiple quotes (from each of the participants) are prohibited. Only one quote for the entire account may be given. Such an account is "managed" like a new issue syndicate, with all sales directed through the manager of the account. It is the manager who makes all decisions for the account; and it is the manager who places the single allowed quote.

If each syndicate member were allowed to place his or her own quote, then it would appear that there are many more market makers in this security than actually exist (there really is only one, that is, the market made by the joint account). Multiple quotes would be a prohibited "deceptive and unfair practice."

**Quotes By
Broker's Brokers**

The quotation rule also applies to municipal "broker's brokers." These are professional trading firms (there are only a handful of such firms in existence), that execute transactions for other institutional brokers on an agency basis only. In these transactions, the institutional broker's identity is kept secret. Thus, the marketplace is not disrupted with the knowledge that an institutional broker is dumping (or accumulating) a large position.

Under this rule, a broker's broker that enters a quote on behalf of another firm must have no reason to believe that the quote is not bona-fide.

**4b. MSRB RULE G-17, UNFAIR DEALING
WITH CUSTOMERS**

**Prohibition On
Unfair Dealing
With Customers**

Rule G-17 simply states that every municipal broker-dealer must deal fairly with all persons, and must not engage in any deceptive, dishonest, or unfair practice. In its interpretations of this rule, the MSRB specifies the following as "no-no's:"

Failing to deliver securities to customers in a prompt fashion;

Allocating "partial calls" by issuers to customer positions in that bond issue, while excluding proprietary positions. The allocation must be made fairly among **all** positions held;

Accepting payment for when issued municipal securities before final settlement **without** treating the advance payment as a "free credit balance" upon which interest is paid;

Not advising customers that interest paid on "free credit balances" held at the firm is taxable income to the customer;

Selling municipal bonds to customers without disclosing, prior to the transaction, all relevant call or put features included by the issuer;

Failing to disclose to a customer that a security is subject to a secondary market credit enhancement (e.g., insurance);

Failing to disclose to a customer that the dealer has issued a put option on that security (another type of secondary market credit enhancement). This disclosure is only required from the dealer that issued the put option, when selling the bonds to its

customers. It is **not** required for other dealers selling this bond (who would be unaware of the existence of that specific put option contract issued by that dealer);

Refusing to submit to arbitration at the "instance" of a customer or another dealer (that is, where these persons initiate the arbitration proceeding);

Failing to disclose material facts to a customer about a transaction (regardless of whether the trade was unsolicited or unsolicited). Note that this does not apply to transactions with SMMPs (Sophisticated Municipal Market Professionals).

This listing is not all inclusive. The basic idea is clear, which is that unethical practices in dealing with customers are violations.

**Cannot Sell A
Security To A
Customer Below
Minimum
Denomination**

In an amendment to its rules, effective in mid-2002, the MSRB also made it illegal to effect municipal securities trades for customers in amounts less than the minimum denomination of that bond issue. For example, if a book-entry bond trades in minimum \$100,000 units, a dealer cannot effect a trade for that customer for, say, \$5,000 of that bond.

Issuers often set high minimum denominations (typically \$100,000 or more) to get around the requirements of Rule 15c2-12 that obligate the underwriter to obtain an Official Statement and perform due diligence on it (covered in a later chapter) or to make the issue inaccessible to a small investor - for whom the issuer believes that the security is not appropriate, usually due to higher than normal risk factors.

The only exceptions to this "minimum denomination" rule are:

A dealer may purchase a below minimum denomination position from a customer provided that the customer is liquidating his or her entire position; and

A dealer may sell such a liquidated position to another customer provided that the customer is given written disclosure that the security position is below minimum denomination and that its liquidity may be adversely affected by this fact.

(These exceptions allow customers that purchased municipal securities in lower than minimum denominations prior to the adoption of this rule to liquidate those positions prior to maturity.)

**Written Disclosure
Of Impaired
Liquidity**

If a dealer sells a municipal security to a customer in less than the minimum denomination, it is a violation not to disclose to the customer, either on the confirmation or separately in writing, that the liquidity of such a security is adversely affected

4c. MSRB RULE G-14, REPORTS OF SALES AND PURCHASES

**Only "True" Trades
May Be Reported**

Rule G-14 states that municipal broker-dealers are prohibited from disseminating a report of a trade unless it is known that an actual transaction occurred at that price. Fictitious trade reports are considered to be a deceptive and manipulative practice.

**RTRS - Real-time
Transaction
Reporting System**

In mid-2005, the MSRB completed the implementation of a real-time trade reporting system for municipal securities, appropriately called "RTRS" - Real-time Transaction Reporting System. As a general rule, trades in municipal securities must be reported to RTRS within 15 minutes of execution.

**Trades Reported
Within 15 Minutes**

To be set-up for trade reporting, the MSRB requires that each member complete a Form G-14 RTRS that includes:

Executing broker symbol ("EBS"), which is obtained from FINRA);

The manner in which transactions will be reported (e.g., by that member or by an executing agent for the member);

The identity of, and information on, any intermediary used by the member to submit reports;

Information on personnel to be contacted if there are problems with RTRS submissions.

**Every Member Firm
Must File Form RTRS**

The information must be kept current and the MSRB must be notified of changes. Also note that the MSRB requires a Form G-14 RTRS filing from every member - no exceptions. It makes no difference if the member does not execute municipal transactions (e.g., it may only advise on new issue structurings) or only offers municipal fund securities where the trades are not reported - these firms are still required to file!

**RTRS Business Hours
7:30 AM - 6:30 PM ET**

As trades in municipal securities occur, between the hours of 7:30 AM to 6:30 PM Eastern Time, both the buyer and the seller must report within 15 minutes of execution (the MSRB then filters this information to eliminate double reporting). Since both the buyer and seller report, the

**Reported Within 15
Minutes**

**Reported By Both
Buyer And Seller**

MSRB can easily identify a firm that failed to make a required report - since, presumably, the other side of the trade will have made the report.

Note that if the trade is eligible for automated comparison at NSCC (National Securities Clearing Corporation), then NSCC uses the comparison information to report the trade to RTRS. Otherwise, the MSRB provides software to the dealer to make the reports.

The required information reported to RTRS includes:

CUSIP number;

Trade date and settlement date;

Time of execution (Eastern time);

Dealer identifier (each municipal firm has a unique executing broker symbol - "EBS," which is assigned by FINRA);

Buy/Sell indicator;

Agency/Principal indicator;

Par value traded;

Dollar price and yield.

Also note that short sales are reported, though these happen infrequently in the municipal market. If a trade report is made after the required 15 minute deadline, it must be reported as "LATE." Reporting is only required from municipal brokers and dealers, not from municipal issuers

Note that firms that do not clear their own securities transactions (called "introducing broker-dealers" since they introduce their accounts to a clearing firm) are not responsible for reporting trades - this is done by the clearing firm. But, the introducing broker-dealer is responsible for reviewing all trade reports made by the clearing firm on its behalf, to insure that the trade submissions were accurate and timely.

RTRS "Business" hours are 7:30 AM - 6:30 PM ET. Any trades that occur during these hours must be reported within 15 minutes. Note, however that the RTRS System is open for trade input from 7:00 AM - 8:00 PM ET. This is called "System Hours." The intent of the later System close is to allow dealers to report late trades or correct mistakes found after the close. In addition, certain types of trades are reported to RTRS at the end of the day (for example,

syndicate trades executed at list price). These can be reported until 8:00 PM, when the system closes.

Regarding after-hours trades, RTRS is closed for trade input at 8:00 PM ET. If a trade occurs after the "cutoff," it still is required to be reported in a "timely manner." RTRS rules require that the trade either be reported within 15 minutes of the "Business Day" opening the next day (7:30 AM), so that trade must be reported by 7:45 AM the next day; or the reporting member can enter the trade in MQ (an IBM software program for messaging that RTRS uses) on Monday. The trades in MQ are held pending for processing and reporting the next day at system opening (7:00 AM).

No real time reporting to RTRS is required for:

Transaction that occur outside of regular RTRS hours (either before 7:30 AM or after 6:30 PM ET). These must be reported within 15 minutes of the next RTRS business hours opening; or alternatively, the trade can be put into MQ for processing and reporting at the next system opening;

Transactions in new issues at the full offering price on the first day of trading - these must be reported by the end of the RTRS system day;

Transactions in municipal money market instruments maturing within 9 months - these must also be reported by the end of the RTRS business day (Also note that the MSRB has amended the RTRS system to require the reporting of data on auctions and yield resets for Auction Rate Securities and for Variable Rate Demand Obligations. This is called the "SHORT" system and is covered later in this section.);

Inter-dealer transactions that are not compared by NSCC.

Step-Out Transactions Are Not Reported

An example of an inter-dealer transaction that is not to be reported is when an investment adviser that has a "prime broker" effects a trade with another executing dealer and then directs that dealer to deliver the securities to the "prime broker" for custody. The delivery between the executing dealer and the prime broker can be handled on an automated basis through NSCC, but the delivery must not be reported as a trade. The NSCC allows comparison submissions to be identified as a "step-out," meaning that the comparison does not represent a reportable trade.

If either party fails to identify such a transaction as a "step-out," then a trade report will be made by NSCC, even though no trade occurred. This is a violation of Rule G-14

(the MSRB has made this a **"BOLD"** item in their rule interpretations, so it should be known for the exam!).

Trade Reversal

Finally, the MSRB is concerned about the reporting of erroneous trades and tracks trade reports that are later reversed. It certainly does not look good if there are a large number of reported trades that are subsequently reversed because they were improperly reported (e.g., wrong price, wrong security, etc.).

To reverse a reported trade, both the buyer and seller must report the reversal to RTTM (Real Time Transaction Matching service) within 15 minutes. These canceled trades are reported on a real-time basis by RTRS. To attempt to minimize these reversals, the MSRB keeps statistics on the percentage of trades reversed by each dealer - and those dealers that have high percentages of reversed trades can expect an audit!

In addition to RTRS, in mid-2009, the MSRB started a system called "SHORT" to collect and disseminate trade information about the short-term municipal market - specifically Auction Rate Securities (ARSs) and Variable Rate Demand Obligations (VRDOs).

SHORT - Reports On ARSs and VRDOs

"SHORT" - the Short-Term Obligation Rate Transparency System - reports results of the periodic auctions for ARSs and the result of each "reset" for VRDOs. The reports include the:

Auction Date and Time;

CUSIP Number;

Program Dealers;

Interest Rate;

Length of Interest Rate Reset Period (time until next auction);

Rate Type (how the interest rate was determined);

Minimum Denomination (minimum dollar amount to participate in auction); and

Minimum and Maximum Rates (usually there is a minimum default rate if there is a lack of bids - this is set quite low; and there is a maximum rate that the issuer will pay if all the rates bid are excessively high - which could happen in a time or market panic).

Data submission must occur the end of the RTRS business day (6:30 PM ET) on the date the auction or reset occurred. Also note that the details of VRDOs and ARSs are covered in the last chapter of this text.

4d. RULE G-18, EXECUTION OF TRANSACTIONS

Obligation To Obtain A Fair Price

Rule G-18 states that, when executing municipal transactions for customers, every broker-dealer is obligated to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions. The rule only applies to agency transactions - not to principal transactions. Since municipal "broker's brokers" only effect agency trades, the rule applies to these firms as well.

Please note that the rule does not require firms to secure the best price; it only requires that the price be fair and reasonable, and reflect current market conditions for that security.

4e. MSRB RULE G-24, USE OF OWNERSHIP INFORMATION OBTAINED IN A FIDUCIARY CAPACITY

When acting as an agent or in a fiduciary capacity for an issuer of securities, a municipal firm may be given, or have access to, ownership information regarding the issuer's securities (e.g., the firm may see a list of all owners of the issuer's bonds).

For example, a bank dealer may act as paying agent for a municipality, and in this capacity, the bank has the list of all registered bondholders.

The rule prohibits the bank from using the list for **any** reason, other than for the intended purpose, which in this case, is making payments on behalf of the issuer to the bondholders. Thus, the bank cannot use the list to solicit these individuals to buy securities; or to solicit these individuals to sell the bonds of that issuer that they hold.

However, if the issuer gives consent to the use of the list, these activities would be permitted (though it is highly unlikely that consent would be given by the issuer).

4f. MSRB RULE G-31, ANTI-RECIPROCAL RULE

Rule G-31 states that municipal broker-dealers are prohibited from soliciting orders for the accounts of investment companies, as compensation, or in return for, sales of fund shares. In other words, an investment company cannot "compensate" a broker-dealer for selling its fund shares by directing fund portfolio trades through that broker-dealer.

For example, it would be prohibited for your firm to approach ACME Municipal Fund and say "Since we sell so much of ACME Municipal Fund shares, we believe that it is in the best interest of your fund to execute its portfolio transactions through our firm."

Implicit in this statement are two violations:

1. There is a subtle form of extortion going on here, because the implication is that if the fund's portfolio trades are not directed to the municipal dealer, then the municipal dealer will not actively sell that fund's shares; and
2. There is a "quid pro quo" arrangement here that does not benefit the customer, e.g. the municipal firm has the incentive to "push" the fund's shares on its customers, even if they are not really suitable (since the firm is being compensated, in turn, for sales of that fund with commissions earned on fund portfolio transactions directed to that firm).

Such an arrangement is prohibited under this rule.

However, the fund is permitted to select a broker-dealer to effect its portfolio transactions based upon the following factors:

1. Execution capability;
2. Research capability
3. Other financial services capability.

4 g. MSRB RULE G-33, CALCULATIONS

MSRB Rule G-33 describes the method by which certain calculations must be made. Among other things, the rule standardizes the method of computing:

Accrued interest;

Dollar prices for trades effected on a yield basis;

Yields for trades effected on a dollar basis.

Please note that Rule G-33 does not deal with the computation of "Net Interest Cost," or "True Interest Cost." These are methods of computing the interest cost to the issuer in a competitive bid underwriting. The issuer uses these computations to decide which bid represents the lowest interest cost. Since the MSRB does not regulate municipal issuers, these computations are outside of the scope of this rule.

The rule is lengthy, and only a basic knowledge is needed for the exam. The following should be known:

Accrued Interest: Should be computed and truncated to 3 decimal places, and rounded to 2 decimal places for disclosure purposes.

For example, \$387.42622 of accrued interest is truncated ("cut" or "shortened") to 3 decimal places, or \$387.426. It is then disclosed at \$387.43 (rounded to 2 decimal places) on the confirmation (this makes sense, since the minimum denomination in which this can be paid is \$.01, that is, one cent).

Dollar Price: Should be computed and then truncated to 3 decimal places, and presented as such on the confirmation.

For example, a bond price of 102.64341 is truncated to 102.643% of \$1,000 par value. The price is shown as \$1,026.43 for the bond.

Yield: Should be computed and then truncated to 4 decimal places, and rounded to 3 decimal places (round up for 5 or above; round down for 4 or below).

For example, a yield computed at 5.10688 should be truncated to 5.1069 (after rounding). The yield shown on the customer confirmation is 5.107%. For example, a yield computed at 5.16442 should be truncated to 5.1644 (after rounding). The yield shown on the customer confirmation is 5.164%.

(Please note that an exception to 3 place rounding is provided for non-callable bonds quoted on a dollar basis. Here the MSRB permits the rounding of the yield to the nearest .05% on the confirmation.)

4h. MSRB RULE G-43, BROKERS' BROKERS

Broker's Broker Fronts Institution That Wishes To Acquire Or Dispose Of A Block Of Bonds

A municipal broker's broker, as noted earlier in this chapter, is a "front man" who fronts an institution that wishes to acquire or dispose of a block of bonds, keeping the institution's identity secret. The broker's broker is a professional trading firm that executes trades for other dealers (the institutions) on an agency basis only. The advantage for the institution is that the institution's trading intent is kept secret and the trade is handled by a highly experienced and skilled trader, who will get the best execution for the institution.

When an institution wishes to buy a block of bonds, the broker's broker may place an "OW" - Offer Wanted - in a dealer bond listing such as Bloomberg; and when an institution wishes to sell a block of bonds, the broker's broker may place a "BW" - Bid Wanted.

Rule G-43 requires that the broker's broker make a reasonable effort to obtain a price for the dealer that is fair and reasonable, given market conditions.

BW Placed By Broker's Broker Means Firm Is Acting For The Seller

When the broker's broker is placing a "BW," the broker's broker is presumed to be acting on behalf of the seller, and thus is attempting to get the highest price;

OW Placed By Broker's Broker Means Firm Is Acting For The Buyer

When the broker's broker is placing an "OW," the broker's broker is presumed to be acting on behalf of the buyer, and thus is attempting to get the lowest price.

This basic obligation can only be changed if the parties involved agree in writing (not likely)!

Most often, broker's brokers are acting for institutional sellers who wish to dispose of large blocks of bonds. G-43 details how "Bid Wanted" auctions are to be conducted.

BW Must Be Widely Disseminated

To obtain exposure to multiple dealers with possible interest in a block of securities, a broker's broker must make an effort to disseminate a "BW" widely, including but not limited to, the underwriter of the issue and prior known bidders on the issue.

BW Conditions

Each "Bid Wanted:"

must have a deadline, after which bids cannot be accepted or changed;

cannot specify a minimum or desired price; and

cannot disclose the identities of the bidders or the seller until the conclusion of the auction.

Prior to placing a "BW," the broker's broker should determine the high and low price parameters for the bids in order to identify those that do not represent a fair market value for the securities. These parameters must be disclosed on the firm's web site. If the high bid received is below the low price parameter, this must be disclosed by the broker's broker to the seller, who can agree to the trade at that price, either orally or in writing.

BW Policies Disclosed To Seller

Finally, Rule G-43 requires broker's brokers to disclose their policies and procedures regarding "Bids Wanted" to the sellers of, and bidders for, municipal securities in writing at least annually. It also requires the broker's broker to post these procedures in a prominent position on the firm's web site.

Minimum Requirements

The policies and procedures of a broker's broker must at a minimum:

provide sellers and bidders with a copy of the firm's commission schedule, which must reflect the maximum charge that could be imposed on a given transaction;

require disclosure to the seller, prior to execution, of the high bid and cover bid (next highest bid), and if these have been changed during the auction, the original and changed bids must be disclosed;

require disclosure to the seller if it allows its customers or affiliates to place bids. If the high bid is from a customer or affiliate, this fact must be disclosed (but there is no disclosure of the customer or affiliate's name);

prohibit preferential treatment - a specific bidder cannot be given a "last look" and it may not be suggested to specific bidders that they should "review" their bids;

require disclosure to the seller of all bid prices at the conclusion of the auction. The winning bidder may only receive notice that its bid is the winning bid.