

**MEMO# 13757**

July 23, 2001

## **MSRB REVISED DRAFT GUIDANCE ON APPLICATION OF MSRB RULES TO TRANSACTIONS WITH SOPHISTICATED MUNICIPAL MARKET PROFESSIONALS**

[13757] July 23, 2001 TO: FIXED-INCOME ADVISORY COMMITTEE No. 11-01 RE: MSRB REVISED DRAFT GUIDANCE ON APPLICATION OF MSRB RULES TO TRANSACTIONS WITH SOPHISTICATED MUNICIPAL MARKET PROFESSIONALS The Municipal Securities Rulemaking Board ("MSRB") has issued a revised draft release providing interpretive guidance on MSRB Rule G-17 – disclosure of material facts, and the application of various MSRB rules to transactions with sophisticated municipal market professionals.<sup>1</sup> The Revised Draft Guidance modifies the MSRB's earlier version of its draft guidance regarding the responsibilities of dealers under the MSRB's fair practice, quotation, uniform practice and new issue securities rules.<sup>2</sup> As you recall, that guidance also introduced the MSRB's controversial sophisticated market professional concept. The Revised Draft Guidance is attached, and it is summarized below. Comments on the Revised Draft Guidance are due by October 1, 2001. If there are comments that you would like the Institute to consider in its comment letter, please contact Barry Simmons at (202) 326-5923 (phone), (202) 326-5827 (fax) or bsimmons@ici.org (email) by Friday, August 24, 2001.

I. Rule G-17 Interpretive Guidance – Disclosure of Material Facts The Revised Draft Guidance clarifies the scope of a dealer's affirmative disclosure obligations under MSRB Rule G-17 and provides an expanded explanation of what the rule's obligation to "disclose all material facts" means in today's market. The Guidance reaffirms a dealer's obligation to disclose to a customer at the time of trade all material facts about a transaction known by the dealer. The Guidance adds that a dealer is also required to discover and thus to disclose material facts about a security when such facts are reasonably accessible to the market. This would include any material fact concerning a municipal security transaction made publicly available through information sources such as the Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs"), State Information Depositories 1 Notice and Draft Interpretive Guidance on Rule G-17 – Disclosure of Material Facts and Interpretive Guidance Concerning Sophisticated Municipal Market Professionals, dated July 6, 2001 ("Revised Draft Guidance"). 2 Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions, dated September 28, 2000. 2("SIDs"), the MSRB's Municipal Securities Information Library® ("MSIL®") system and Transaction Reporting System ("TRS"), among others. The Revised Draft Guidance notes that Rule G-17's duty to "deal fairly" is intended to "refer to the customs and practices of the municipal securities market," and adds that such customs and practices suggest that the information sources generally used by a dealer in effecting

municipal securities transactions may vary with the type of municipal security. Thus, the more complex the security, or where credit quality is changing rapidly, the broader the range of information sources that the dealer may need to review before executing the transaction.

**II. Sophisticated Municipal Market Professional Interpretive Guidance**

In its previous draft guidance, the MSRB expressed the view that the manner in which a dealer could satisfy customer protection obligations under MSRB rules is based on the nature of the customer. In that guidance, the MSRB defined a class of customers as “sophisticated market professionals” (or “SMPs”) and stated that, in general, the specific actions necessary for the dealer to assure that fair practice standards are met with respect to retail customers and unsophisticated institutional customers may be more comprehensive than the actions required when effecting transactions with or for customers who are SMPs.<sup>3</sup> The MSRB has determined to retain the SMP concept, but has narrowed its scope somewhat as described below. In particular, the MSRB has modified the SMP concept in recognition that: (1) individuals should not be considered to be SMPs; (2) the SMP name should be changed to “sophisticated municipal market professional” (“SMMP”); and (3) application of the SMMP concept should closely adhere to the language in the NASD Institutional Suitability Release, so as to make the application of the SMMP concept less confusing to dealers who must comply with both. In addition, the MSRB has further modified the SMMP concept by limiting its application to institutions with at least \$100 million invested in municipal securities in the aggregate and/or under management. The Revised Draft Guidance provides that the factors for determining that an institutional customer is an SMMP are merely guidelines for determining whether a dealer has fulfilled its fair practice obligations with respect to a specific institutional customer and that the inclusion or absence of any of these factors is not dispositive of the determination.

**a. Rule G-17: Conduct of Municipal Securities Activities**

The Revised Draft Guidance underscores the MSRB’s view that the actions of a dealer in complying with the affirmative disclosure obligations under Rule G-17 may depend on the nature of the customer. The MSRB makes clear, however, that this concept only applies when a dealer is effecting non-recommended secondary market transactions for a customer, and not for dealers who effect transactions in new issue securities, or who recommend securities transactions. In the latter instance, those dealers may have additional pricing, disclosure, suitability and investigation obligations. Thus, under the SMMP concept, a dealer’s affirmative disclosure obligations are fulfilled when it effects non-recommended secondary market transactions for a customer that it reasonably concludes is an SMMP. The MSRB explains that this interpretation thus allows dealers to act as “order-takers” when transacting with SMMPs. The Revised Draft Guidance discusses electronic trading platforms and the risks inherent to the platform participants. The Guidance explains that a dealer operating an electronic trading platform, like an alternative trading system (“ATS”), is not likely to have any unique knowledge about the securities being traded on its system. As such, system participants must have the sophistication to understand the consequences of transacting with a dealer who is offering transaction execution services only and who does not have, and does not represent that it has, a unique knowledge about the security transactions being effected on its trading platform.

**b. Rule G-18: Execution of Transactions**

The Revised Draft Guidance reiterates that a dealer’s reasonable efforts to ensure that its agency transactions with customers are effected at fair and reasonable prices may be influenced by the nature of the customer as well as by the services explicitly offered by the dealer. The Guidance describes the parameters of such services and notes that if a dealer, in effecting non-recommended secondary market agency transactions for an SMMP,

provides services that are limited to providing anonymity, communication, order matching, and/or clearance functions, and does not exercise discretion as to how or when the transaction is executed, then the dealer (or system operator in the case of an electronic trading platform) is not required to take further actions on individual transactions to ensure that its agency transactions with customers are effected at fair and reasonable prices. c. Rule G-19: Suitability of Recommendations and Transactions The Revised Draft Guidance clarifies that the interpretive guidance on Rule G-19 concerns only the manner in which a dealer determines that a recommendation is suitable for a particular institutional customer. The Guidance further clarifies that the manner in which a dealer fulfills its “customer-specific suitability obligations” will vary depending on the nature of the customer and the specific transaction. Accordingly, the Guidance states that where the dealer has reasonable grounds for concluding that an institutional customer is an SMMP, then a dealer’s obligation to determine that a recommendation is suitable for that particular customer is fulfilled. The Revised Draft Guidance does not address the facts and circumstances that go into determining whether an electronic communication does or does not constitute a “recommendation.” However, in response to commenters’ calls for industry consensus on the definition of an online recommendation, the Guidance announced that the MSRB is reviewing the NASD’s suitability rule and online communication release and plans to provide additional guidance in this area. Barry E. Simmons Associate Counsel Attachment 4Attachment (in .pdf format)