

MEMO# 13741

July 18, 2001

MSRB ADOPTS RULE RELATING TO PRINCIPALS AND SEEKS COMMENT ON APPLICATION OF MSRB RULES TO MUNICIPAL FUND SECURITIES

[13741] July 18, 2001 TO: 529 PLAN ADVISORY COMMITTEE No. 4-01 BROKER/DEALER ADVISORY COMMITTEE No. 18-01 RE: MSRB ADOPTS RULE RELATING TO PRINCIPALS AND SEEKS COMMENT ON APPLICATION OF MSRB RULES TO MUNICIPAL FUND SECURITIES The Municipal Securities Rulemaking Board (MSRB) recently issued the attached notice (i) announcing a proposed revision to Rule G-3 to temporarily waive the qualification requirements for certain municipal securities principals (MSPs); and (ii) providing guidance on the application to municipal fund securities¹ of various MSRB rules relating to fees, disclosure and other market practices. In addition, the notice seeks comment on issues relating to MSRB Rules 37 and 38, relating to political contributions, and to the multi-tiered distribution of municipal fund securities. The MSRB's notice is summarized below. Comments are due to the MSRB no later than Monday, September 17, 2001. Persons with comments they would like the Institute to consider submitting to the MSRB should contact the undersigned by phone (202-326-5825) or e-mail (tamara@ici.org) no later than Friday, August 31st.

I. AMENDMENTS TO RULE G-3: QUALIFICATION OF MSPS MSRB Rule G-3 requires all municipal securities dealers to have at least one MSP. According to the MSRB's notice, this requirement imposes a "significant barrier to entry" on small firms that are interested in selling municipal fund securities. To provide some relief to such firms, the MSRB has filed with the Securities and Exchange Commission amendments to Rule G-3. Under these amendments, until July 31, 2002 a dealer that (i) has fewer than 11 associated persons engaged in municipal fund securities activities, and (ii) limits its municipal securities activities exclusively to municipal fund securities, may designate an investment company/variable contracts limited principal to act as its MSP. Such designee "will have all of the powers and responsibilities" of an MSP under the MSRB's rules. As of August 1, 2002, when this temporary relief expires, the dealer must have a qualified MSP in order to continue to engage in municipal fund securities activities. ¹ The term "municipal fund securities" was added to the MSRB's rules in January 2001. As defined in MSRB Rule D- 12, the term means a municipal security issued by an issuer that, but for the application of Section 2(b) of the Investment Company Act of 1940, would constitute an investment company thereunder.

II. COMMISSIONS AND OTHER FEES ON SALES OF MUNICIPAL FUND SECURITIES As noted in the MSRB's notice, the nature of commissions and other fees charged in connection with municipal fund securities may differ significantly from those for tradition debt securities sold by municipal dealers. In recognition of these differences, the MSRB's notice offers guidance to dealers effecting transactions in municipal fund securities.

The notice seeks comment on all aspects of this guidance. A. Amount of Commissions and Fees: MSRB Rule G-30 v. NASD Rule 2830 MSRB Rule G-30(b), relating to prices and commissions in agency transactions, prohibits dealers from selling municipal securities to a customer for a commission or service charge “in excess of a fair and reasonable amount.” The MSRB has received inquiries about whether the sales charge schedule set out in National Association of Securities Dealers (NASD) Rule 2830 applies to the level of commissions and fees that dealers may charge in connection with sales of municipal fund securities. According to the MSRB, while NASD Rule 2830 may “provide some relevant information in determining whether a dealer selling municipal fund securities is charging a commission or other fee that is fair and reasonable, the NASD schedule is by no means dispositive nor is it the principal factor in determining compliance with rule G-30.” (Emphasis added.) B. Required Confirmation Disclosure of Fees and Other Charges MSRB Rules G-15 and G-32 set forth certain obligations of dealers to disclose fees and other charges received in connection with municipal securities transactions.² According to the notice, Rule G-15 requires a dealer to disclose on the transaction confirmation: (1) the nature and amount of any miscellaneous fees charged in connection with the transaction; (2) the amount of any remuneration received or to be received by the dealer from the customer, unless the remuneration is not on a transaction basis; (3) the source and amount of any remuneration paid by any person other than the customer in connection with the transaction or a statement that such remuneration has been paid and information regarding the source and amount of such payment will be provided upon written request; and (4) if a deferred commission or other charge is imposed upon redemption, the customer must be informed that it may be required to make such deferred payment and information concerning it will be furnished upon written request. In addition to this disclosure, Rule G-32 requires the dealer to disclose to the customer, by settlement, any underwriting spread and the amount of any fee received by the dealer as agent for the issuer in the distribution of the securities. If the dealer provides periodic statements in lieu of individual transaction confirmations, the dealer may instead provide information regarding the agency fee to the customer at least annually and information regarding any change in such fee on or prior to sending the next succeeding period statement to the customer. C. Additional Disclosure Considerations According to the notice, the MSRB’s rules do not explicitly require disclosure by dealers of fees and charges received by other parties to a transaction (e.g., administrative fees of the 2 MSRB Rule G-15 governs confirmations, and clearance and settlement of transactions. Rule G-32 governs disclosures in connection with new issues. 3 issuer or investment adviser payable from trust assets or directly from the customer). The rules may, however, implicitly require such disclosure. The MSRB believes that, in most respects, the disclosures provided by the issuer in the official statement would provide the dealer with the type of information it is required to disclose to customers under Rule G-17, the MSRB’s fair dealing rule. With respect to advertising, the notice notes that the MSRB has previously stated that any use of historical yields in an advertisement is subject to Rule G-21’s prohibition against publishing or distributing any advertisements relating to municipal fund securities that are materially false or misleading. According to the MSRB, an advertisement referring to yield typically would require a description of the nature and significance of the yield shown in order to assure that it is not false or misleading. III. SUBMISSION OF OFFICIAL STATEMENTS TO THE MSRB The notice reiterates the previously expressed view of the MSRB that the primary distributor for the offering has the responsibility to undertake all actions required by Rule G-36, relating to the delivery of official statements and the filing of Form G-36(OS), as well as the corresponding recordkeeping requirements of Rule G-8. The notice also states that the MSRB believes that any selling dealers for the offering that might be considered underwriters may rely on the primary distributor to undertake these actions to the same extent as if they had, in fact,

formed an underwriting syndicate. The notice includes a supplement to the MSRB's Form G-36 Manual to assist dealers in completing Form G-36(OS) for an offering of municipal fund securities. IV. POLITICAL CONTRIBUTIONS: RULES G-37 AND G-38 According to the MSRB, absent unusual circumstances, the primary distributor of municipal fund securities should be considered to be engaged in the municipal securities business for purposes of Rules G-37 and G-38. The MSRB also takes the view that dealers that are syndicate members for a particular offering should report such offering as municipal securities business; while dealers that are selling group members are not considered to be engaged in the municipal securities business. The MSRB notice raises two issues concerning the application of Rules G-37 and G-38: (1) whether the selling dealers in a multi-tiered distribution system should be considered to be engaged in municipal securities business; and (2) whether the role of a syndicate member should be distinguished from the role of a selling group member based upon (a) the nature of the contractual relationship among the dealers and the issuers or (b) whether a particular firm meets, or is excepted from, the definition of "underwriter" in Rule 15c2-12 under the Securities Exchange Act of 1934. The notice notes that, irrespective of whether the dealer is considered to be engaged in the municipal securities business, the dealer nonetheless generally is subject to the reporting requirements of Rules G-37 and G-38 and Rule G-8's related recordkeeping requirements. Thus the dealer must determine whether any of its associated persons are MFPs or non-MFP executive officers, or whether any other person is a consultant of the dealer. If so, the dealer must collect and report the requisite information regarding such persons' political contributions. 3 See also Memorandum to 529 Advisory Committee No. 2-01, dated June 12, 2001, relating to the MSRB's recent proposal seeking comment on Rule G-37, which governs political contributions. Comments on that proposal are due to the MSRB by September 28th. 4V. PRINCIPAL/AGENCY CAPACITY OF DEALER The notice expresses the understanding of the MSRB that sales of municipal fund securities currently are made primarily, if not exclusively, on an agency basis. It then seeks comment on the views of industry regarding the capacity in which primary distributors and selling dealers in multi-tiered distribution systems effect transactions in municipal fund securities -- i.e., in an agency or principal (including as a "riskless principal") capacity. In particular, the MSRB seeks comment on the following issues: • Does a customer acquiring a municipal fund security through a selling dealer in a multi-tiered distribution system purchase the security from the selling dealer as a principal? • Does the selling dealer, as agent, effect a transaction between the customer and the primary distributor? Or between the customer and the issuer? • Is the selling dealer merely a finder, with the transaction being effected between the customer and the primary distributor, as principal, or between the customer and the issuer, with the primary distributor acting as agent? • Are there circumstances in which inter-dealer trades in municipal fund securities occur, particularly in a multi-tiered distribution system? If so, would any aspects of such transactions conflict with Rule G-12 on uniform practice?4 Would application of G-12 alter the way inter-dealer municipal fund securities transactions may currently be handled? • Is an explicit exemption from the inter-dealer transaction reporting requirements of Rule G-14 needed?5 Conversely, should the MSRB revisit its prior decision to exempt customer transactions in municipal fund securities from transaction reporting? and • Do the provisions of MSRB Rule G-12 relating to confirmation of inter-dealer transactions need to be revised to address inter-dealer transactions in municipal fund securities?6 Tamara K. Reed Associate Counsel Attachment Attachment (in .pdf format) 4 As noted in the notice, MSRB Rule G-12 provides, among other things, that any inter-dealer transactions eligible for automated trade comparison through a registered clearing agency must be compared through such an agency and any inter-dealer transaction eligible for book-entry settlement at a registered securities depository must be settled through one or more such depositories. 5 MSRB Rule G-14 requires that an inter-dealer transaction that is

eligible for automated comparison by NSCC be reported to NSCC on reports of sales or purchases. Municipal fund securities transactions with customers have previously been exempted from the customer transaction reporting requirements of the rule. 6 According to the notice, because inter-dealer transactions in municipal fund securities were believed by the MSRB not to exist at the time it amended Rule G-15 to provide for confirmation of municipal fund securities transactions with customers, comparable provisions of the Rule G-12 inter-dealer confirmation requirements were not similarly amended.

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