

**MEMO# 12782**

October 24, 2000

# **MSRB DRAFT INTERPRETIVE GUIDANCE ON DEALER RESPONSIBILITIES IN CONNECTION WITH MUNICIPAL SECURITIES TRANSACTIONS**

[12782] October 24, 2000 TO: FIXED-INCOME ADVISORY COMMITTEE No. 9-00 RE: MSRB DRAFT INTERPRETIVE GUIDANCE ON DEALER RESPONSIBILITIES IN CONNECTION WITH MUNICIPAL SECURITIES TRANSACTIONS The Municipal Securities Rulemaking Board ("MSRB") has issued a notice and request for comment on draft interpretive guidance in connection with the responsibilities of brokers, dealers and municipal securities dealers ("dealers") under the MSRB's fair practice, quotation, uniform practice and new issue securities rules.<sup>1</sup> As part of this interpretive guidance, the MSRB also proposes to define a class of customers as sophisticated market professionals. The draft interpretive guidance would apply to both electronic and traditional municipal securities transactions. The MSRB's notice is attached, and it is summarized below. The comment period ends December 1, 2000. If there are comments you would like the Institute to include in its comment letter, please contact Barry Simmons at (202) 326-5923 (phone), (202) 326-5827 (fax) or bsimmons@ici.org (email) by Wednesday, November 8, 2000.

**I. SOPHISTICATED MARKET PROFESSIONALS** The Notice states that in order to facilitate the implementation of the MSRB's draft interpretive guidance, the MSRB proposes to define a class of customers as sophisticated market professionals ("SMPs"). This designation would be made by the dealer and would signify that the customer is on an equal informational footing with the transacting dealer. Accordingly, the level of a dealer's fair practice obligations with respect to a transaction with an SMP would be reduced. The Notice states that in determining whether a customer is an SMP, the dealer would look to whether the customer: (1) has timely access to all publicly available material facts concerning a transaction; (2) is capable of independently evaluating the investment risk and market value of the securities at issue; and (3) is making independent investment decisions. The Notice provides the following non-exclusive list of factors a dealer may consider in determining whether each criteria is satisfied.

1 Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions, dated September 28, 2000 ("Notice").

2 A. Access to Publicly Available Information In determining whether a customer has access to publicly available information a dealer may consider:

1. the resources available to the customer to investigate the transaction (i.e., research analysis);
2. the customer's independent access to the Nationally Recognized Municipal Securities Information Repository ("NRMSIRs"), State Information Depositories ("SIDs"), and information generated by the MSRB's Municipal Securities Information Library® ("MSIL®") system and Transaction Reporting System, either directly or through services that

subscribe to such systems; and 3. the customer's access to other sources of information concerning material financial developments affecting an issuer's securities (i.e., rating agency data).

**B. Independent Evaluation of Investment Risk and Market Value Considerations** In determining whether a customer is capable of independently evaluating investment risk and market value considerations, a dealer may consider: 1. the use of one or more consultants, investment advisers, research analysts or bank trust departments; 2. the general level of experience of the customer in municipal securities markets and specific experience with the type of municipal securities under consideration; 3. the customer's ability to understand the economic features of the security; 4. the customer's ability to independently evaluate how market developments would affect the security that is under consideration; and 5. the complexity of the security or securities involved.

**C. Independent Investment Decisions** In determining whether a customer is capable of making independent investment decisions, a dealer may consider: 1. any written or oral understanding that exists between the dealer and the customer regarding the nature of the relationship between the dealer and the customer and the services to be rendered by the dealer; 2. the presence or absence of a pattern of acceptance of the dealer's recommendations; 3. the use by the customer of ideas, suggestions, market views and information relating to municipal securities obtained from sources other than the dealer; and 34. the extent to which the dealer has received from the customer current comprehensive portfolio information in connection with discussing potential transactions or has not been provided important information regarding the customer's portfolio or investment objectives.

**II. FAIR PRACTICE RULES**

**A. Rule G-17: Conduct of Municipal Securities Activities** The Notice discusses the anti-fraud and fair dealing principles encompassed under Rule G-17 and reiterates the dealer's obligations to provide a complete description of the security and to disclose all material facts. The Notice adds that although this disclosure is required at or before the sale of municipal securities to a customer, no such affirmative disclosure obligation has been interpreted to exist with respect to inter-dealer transactions primarily because dealers are presumed to be market professionals and to know the material facts about the securities that they trade. For these reasons, the MSRB has determined that no such affirmative disclosure obligation exists where the customer is an SMP. The Notice explains that where the dealer has grounds for believing that the customer is an SMP it need not disclose all material public facts concerning the transaction since the SMP would already have timely access to relevant market information.

**B. Rule G-18: Execution of Transactions** The Notice discusses the dealer's duty under Rule G-18 to effect agency transactions in municipal securities at fair and reasonable prices in relation to prevailing market conditions, and points out that this obligation is the same regardless of whether the dealer is acting as agent for a customer or acting for or on behalf of another dealer (i.e., a "broker's broker"). The Notice clarifies, however, that if a dealer effects agency transactions for SMPs and its agency responsibilities have been explicitly limited to providing anonymity, communications, matching and/or clearance functions then it would not be required to take further actions on individual transactions to ensure that its agency transactions with customers are effected at fair and reasonable prices. For dealers operating alternative trading systems ("ATs") in which participation is limited to dealers and SMPs, the Notice clarifies that Rule G-18 does not impose an obligation upon the dealer operating such a system to investigate each individual transaction price to determine its relationship to the market, in partial recognition that such dealers (i.e., system operators) may merely be aggregating the buy and sell interest of other dealers or SMPs. But such an obligation would be imposed if a dealer effects agency transactions for non-SMP customers, or has held itself out to do more than provide anonymity, communication, matching and/or clearance services within the scope of its agency responsibilities to SMPs.

**C. Rule G-19: Suitability of Recommendations and Transactions** The Notice discusses a dealer's obligation

under Rule G-19 to make suitable municipal securities transaction recommendations. The Notice points out that under past rule interpretations dealers are required to make a greater effort to obtain information on which to base a suitability recommendation from a non-institutional account than from an institutional account. On this point, the Notice clarifies that when a dealer has reasonable grounds for concluding that the customer is an SMP with respect to a security, it need not take any further action to ensure that a recommended transaction is suitable for that SMP.

III. QUOTATION RULE A. Rule G-13 The Notice discusses a dealer's responsibility under Rule G-13 for ensuring that a quotation is bona fide and based on the dealer's best judgment of fair market value at the time the quotation is made. The Notice distinguishes between a dealer that disseminates its own quotation, which would trigger the bona fide and fair market value requirements, and a dealer that disseminates a quotation made by another dealer, which would not have the same affirmative obligation, unless the dealer has any reason to believe that either: (i) the quotation does not represent a bona fide bid for, or offer of, municipal securities by the dealer making the quotation, or (ii) the price stated in the quotation is not based on the best judgment of the dealer making the quotation of the fair market value of the securities. The Notice adds that a quotation disseminated by an SMP would be viewed no differently than if it were disseminated by another dealer. In either case, the disseminating dealer's responsibility with respect to such quotations is reduced.

B. Subsequent Events and Stale or Invalid Quotations The Notice points out that although events occurring subsequent to the making of a quotation do not result in a violation of Rule G-13 if the quotation met the bona fide and fair market value requirement at the time the quotation was made, if the quotation becomes stale or invalid because of the subsequent event, it must be withdrawn or updated. The Notice adds that the MSRB has taken the position that in the context of quotations published in a daily or other listing, stale or invalid quotations must be withdrawn or updated in the next publication. But in the context of electronic dissemination of quotations on a continuous basis, the MSRB is of the view that any such stale or invalid quotation should be withdrawn or updated no later than the next business day, or sooner if necessary, to prevent it from becoming misleading as to the dealer's willingness to buy or sell at the stated price.

IV. NEW ISSUE SECURITIES RULES A. General Requirements The Notice discusses several ways in which new issue municipal securities are underwritten, including where a new issue is sold to: (1) a syndicate formed by several dealers of which one serves as the managing underwriter; (2) two or more underwriters that have not formed a syndicate, but instead each underwriter purchases a separate portion of the new issue; and (3) a single dealer that serves as the sole underwriter for the issue. The Notice discusses how certain issuers recently have begun using the electronic "auction" process, where bids are taken from both dealers and investors directly. That process involves the use of dealers to serve as an intermediary, either in the role of auction agent to conduct the auction on the issuer's behalf, or settlement agent to effectuate the transfer of securities from the issuer to the winning bidders and for certain other related purposes.

B. Rule G-32: Disclosures in Connection with New Issues The Notice discusses dealer obligations under Rule G-32 regarding the delivery of official statements for new issues. The Notice explains that for sales of new issues to a customer during the issue's underwriting period, the dealer must deliver the official statement in final form, if any, to the customer by settlement of the transaction. For sales to another dealer, Rule G-32 requires (1) the selling dealer to send the purchasing dealer the statement within one business day of request, and (2) the managing or sole underwriter for the new issue to send the purchasing dealer (regardless of whether the securities were purchased from that underwriter or from another dealer) one official statement plus one additional copy per \$100,000 par value of the new issue municipal securities sold by such dealer to customers.

C. Rule G-36: MSRB Delivery of Official Statements, Advance Refunding Documents and Related Forms The

Notice discusses dealer obligations under Rule G-36 regarding the sending of official statements and advance refunding documents to the MSRB. The Notice explains the responsibilities of a managing or sole underwriter with respect to such filings and notes that, similar to Rule G-32, where multiple underwriters underwrite an offering without forming an underwriting syndicate, each such underwriter would have the role of sole underwriter for purpose of Rule G-36 and thus would be required to send such statements and related forms to the MSRB. Barry E. Simmons Associate Counsel Attachment (in .pdf format)

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.