

MEMO# 14418

February 1, 2002

MSRB INTERPRETIVE NOTICE CONCERNING THE APPLICATION OF CERTAIN BOARD RULES TO TRANSACTIONS WITH "SOPHISTICATED MUNICIPAL MARKET PROFESSIONALS"

[14418] February 1, 2002 TO: FIXED-INCOME ADVISORY COMMITTEE No. 1-02 RE: MSRB INTERPRETIVE NOTICE CONCERNING THE APPLICATION OF CERTAIN BOARD RULES TO TRANSACTIONS WITH "SOPHISTICATED MUNICIPAL MARKET PROFESSIONALS" As we previously informed you,¹ last summer the Municipal Securities Rulemaking Board ("MSRB") issued a revised draft release providing interpretive guidance on the application of various MSRB rules to certain market participants. Specifically, the Revised Draft Guidance provided interpretive guidance on MSRB Rule G-17, and provided an updated, expanded explanation of the meaning of the rule's obligation "to disclose all material facts." The Revised Draft Guidance also provided guidance on the application of MSRB Rule G-17, along with several other MSRB rules, to sophisticated municipal market professionals ("SMMPs"). The MSRB has recently finalized its Revised Draft Guidance and filed an interpretive notice with the Securities and Exchange Commission.² Aside from the modifications discussed below, the Interpretive Notice remains largely unchanged from the Revised Draft Guidance.³ In the Revised Draft Guidance, the MSRB identified several factors that dealers should consider in determining whether an institutional customer is an SMMP.⁴ The Revised Draft Guidance also imposed a threshold requirement that an SMMP own or control \$100 million in municipal securities, and permitted a dealer to satisfy certain of its fair practice obligations with 1 See Memorandum to Fixed-Income Advisory Committee No. 11-01, dated July 23, 2001 ("Revised Draft Guidance"). 2 Interpretive Notice Filed Concerning the Application of Board Rules to Transactions With Sophisticated Municipal Market Professionals, (January 25, 2002) ("Interpretive Notice"). Upon completing its review of the Interpretive Notice, the Commission will issue it for public comment. The Interpretive Notice is available at <http://www.msrb.org/>. 3 The Institute submitted a comment letter on the Revised Draft Guidance. See Memorandum to Fixed-Income Advisory Committee No. 16-01, dated October 24, 2001. 4 Those factors include whether the institutional customer: (1) has timely access to all publicly available material facts concerning a municipal securities transaction; (2) is capable of independently evaluating the investment risk and market value of the municipal securities at issue; and (3) is making independent investment decisions about its investments in municipal securities. 2 respect to any institutional customer that it determines is an SMMP. The Interpretive Notice leaves these provisions unchanged,⁵ but makes other modifications to the SMMP proposal. First, in order

to assist dealers and customers in defining their own expectations and roles with respect to their specific relationship, the MSRB amended the Interpretive Notice to permit dealers the option of having customers attest to SMMP status. The Interpretive Notice explains that this is intended to streamline the process for determining a customer's SMMP status and ensure that customers are informed of the consequences of an SMMP designation. The Interpretive Notice makes clear, however, that a dealer would not be able to rely upon a customer's SMMP attestation if it knew or should have known that an investor lacked sophistication concerning a municipal securities transaction as defined in the SMMP guidance. The MSRB also amended the Interpretive Notice to address the ongoing appropriateness of a customer's SMMP designation. Specifically, in order to determine whether a customer still qualifies as an SMMP, the Interpretive Notice includes a statement that requires dealers to put in place a process for periodic review of a customer's SMMP status. The Interpretive Notice addresses two other related issues. First, the MSRB decided not to follow an Institute recommendation to limit the SMMP concept to electronic trading platforms. In our comment letter, we cautioned that dealers should not be relieved of their disclosure obligations when effecting non-electronic transactions, since this could result in the dilution of dealer responsibilities in traditional trading transactions. We also pointed out that there has been no demonstrated need to expand the SMMP concept to non-electronic trading. In response to these concerns, the MSRB expressed its belief that electronic transactions should not be subject to different regulation than transactions that take place over the phone or in person, and that dealers' obligations should be the same regardless of the medium of communication. Second, the MSRB determined not to exclude certain exempt securities from the application of the SMMP proposal. The Institute recommended excluding from the SMMP proposal transactions in private placement securities and securities exempt from the disclosure requirements of Rule 15c2-12 under the Securities Exchange Act of 1934, such as variable rate demand obligations, because information about these securities is not generally publicly available. Thus, permitting securities to be traded on an electronic platform that are not subject to continuing disclosure obligations could be potentially harmful to investors. In response, the MSRB explains that what underlies the SMMP concept is not that material information is always disclosed to the public by the issuer, but rather, that the SMMP is aware of, or capable of making itself aware, and can independently understand the significance of, the material facts available from established industry sources. Barry E. Simmons Associate Counsel 5 The MSRB decided against reducing the threshold level to \$50 million, as was suggested by various other commenters, noting that the \$100 million is a way of ensuring that SMMPs are "truly the most sophisticated of institutional investors." Similarly, the MSRB decided not to follow the commenters' suggestion to alter the SMMP definition to allow dealers to presume that an investor is "sophisticated" if it meets the \$100 million investment threshold. According to the MSRB, dealers should undertake some level of investigation to determine a customer's SMMP status, rather than merely presuming that an institution is sophisticated just because it meets the threshold.