

2016 Compliance Advisory for Brokers, Dealers and Municipal Securities Dealers



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Municipal Securities Rulemaking Board

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Introduction

The Municipal Securities Rulemaking Board (MSRB) is publishing the 2016 Compliance Advisory (Advisory) to highlight some of the key compliance risks for brokers, dealers and municipal securities dealers (collectively, dealers) that, if not properly addressed, could adversely affect municipal entities, obligated persons, investors and public confidence in the municipal securities market.¹ This Advisory also provides dealers with certain factors to consider when evaluating compliance controls and implementing measures to mitigate exposure to these compliance risks (identified below as Considerations).² The MSRB intends for dealers to use this Advisory as a tool that can be used to supplement the assessment of the adequacy of their compliance programs.³

¹ This Advisory is not intended to address all the requirements of each MSRB Rule or other federal securities laws and is not meant to be exhaustive or tailored to any one firm's business activities. This Advisory is not legal advice and does not create a safe harbor with respect to the potential deficiencies in a dealer's compliance processes or supervisory system.

² These Considerations are not comprehensive and are provided as examples of factors a firm may wish to consider.

³ The MSRB also identifies key compliance risks to assist the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) in the development of regulatory examination programs for dealers consistent with Section 15B(b)(4) of the Securities Exchange Act of 1934.

Compliance Risks

Failure to Adhere to Fair Pricing Standards and Provide Best Execution (MSRB Rules G-30 and G-18)

MSRB Rule G-30, on prices and commissions, and MSRB Rule G-18, on best execution, are designed to ensure, in part, that dealers effect transactions with customers at fair and reasonable prices. Rule G-30 requires a dealer to purchase from, or sell to, a customer at an aggregate price (including mark-up or mark-down) that is fair and reasonable if acting as principal, and at fair and reasonable commissions if acting as an agent. A fair and reasonable price must bear a reasonable relationship to the prevailing market price of the security. The lack of a well-defined and active market for an issue does not negate the need for the dealer to exercise diligence in determining the prevailing market value as accurately as reasonably possible when fair-pricing obligations apply.

Rule G-18, as of March 21, 2016, requires a dealer, in any transaction in a municipal security for or with a customer, or a customer order from another dealer routed for handling and execution, to use reasonable diligence to ascertain the best market for the subject security. The dealer must then buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. A dealer must be especially diligent in ensuring that it has met its best-execution obligations with respect to customer transactions involving securities for which there is limited pricing information or quotations available.



MSRB RULES G-30 AND G-18

CONSIDERATIONS:

- What reasonable diligence does the firm undertake to assess the market value of a security in determining that the aggregate price of a purchase from, or sale to, a customer is fair and reasonable.
- Does the firm have a process to monitor retail orders that are filled from inventory shortly after the dealer completes a primary offering to evaluate whether those orders could have been filled with securities available during the primary offering.
- How does the firm document compliance with its best-execution determinations for securities with limited pricing information or quotations available.
- Does the firm have a process to conduct reviews of its best execution policies and procedures to ensure they are reasonably designed, taking into account the quality of the executions the dealer is obtaining under its current policies and procedures, changes in market structure, new entrants, the availability of additional pre-trade and post-trade data, and the availability of new technologies.

Failure to Satisfy Suitability Obligations (MSRB Rule G-19)

MSRB Rule G-19, on suitability of recommendations and transactions, is fundamental to the fair dealing requirement of MSRB Rule G-17 and is intended to promote ethical sales practices and high standards of professional conduct. Rule G-19 requires a dealer to have a reasonable basis to believe, based on reasonable diligence, that a recommendation it is making to its customer is suitable for a least some investors. This determination requires that the dealer understand the material information regarding the municipal security or strategy and the potential risks and benefits associated with the recommendation. A dealer is also prohibited from recommending transactions in municipal securities to a customer without sufficient information about the customer to have a reasonable belief that the recommendation is suitable based on the customer's investment profile.

Dealers should take particular care with respect to new types of municipal financial products and existing products that may have unique structures that can differ materially from issue to issue. Additionally, outstanding municipal securities may be so complex or risky that they are inherently unsuitable for most retail investors. For example, a dealer could violate the suitability rule if it recommends a municipal security without an understanding of the minimum denomination authorized by the bond documents or that there is a restriction on resales to non-qualified investors.

With regard to recommendations relating to a 529 college savings plan, a dealer must remain cognizant of the fact that these instruments are designed for a particular purpose and the particular plan, or share class, should match the customer's investment objective. For example, a dealer should consider whether a recommendation is consistent with the customer's tax status, bearing in mind that an in-state plan may offer favorable state tax treatment or other valuable benefits to its residents that an out-of-state 529 college savings plan may not.



MSRB RULE G-19

CONSIDERATIONS:

- Does the firm have a process to evaluate material information and the potential risks and benefits associated with a new municipal securities product, municipal fund security or strategy before the product is recommended to any customers.
- What documentation does the firm maintain to evidence its determination that one or more aspects of a customer's investment profile are not relevant to a suitability analysis for a particular recommendation.
- How does the firm evidence that it has undertaken reasonable diligence to form the basis of a suitability analysis with respect to a municipal security where offering documents may not be accessible through reasonable efforts (e.g., a municipal security issued as part of a private placement).
- Does the firm have a process to identify and evaluate recommendations that have resulted in transactions inconsistent with provisions of the official statement and other bond documents, such as stated minimum denominations.

Failure to Disclose Material Information to Customers (MSRB Rule G-47)

MSRB Rule G-47, on time of trade disclosures, prohibits a dealer from selling municipal securities to a customer, or purchasing municipal securities from a customer, without disclosing to the customer, at or prior to the time of trade, all material information known about the transaction as well as the material information about the security that is reasonably accessible to the market. The rule applies regardless of whether the transaction is solicited or unsolicited, occurs in a primary offering or the secondary market, or is a principal or agency transaction.

The rule permits the disclosure to be made to the customer either orally or in writing. The requirements of Rule G-47 do not apply if the dealer has obtained customer affirmation that the customer is a sophisticated municipal market professional (SMMP).



MSRB RULE G-47

CONSIDERATIONS:

- Does the firm have a process for identifying the material information regarding a municipal security that should be disclosed to a customer at the time of trade and how is that information provided to its registered representatives engaged in effecting municipal securities transactions.
- How does the firm evidence that the material information was disclosed to a customer, whether orally or in writing, and that the customer was not merely directed to an established industry source.
- When the municipal securities transactions are effected through an electronic trading system, how does the firm document that time of trade disclosures are made.
- Does the firm have a process to obtain and document affirmations from its SMMP customers, including a process to obtain the broader affirmation required by Rule D-15, as amended, effective March 21, 2016.

Failure to Adhere to Pay-to-Play Restrictions (MSRB Rule G-37)

MSRB Rule G-37, on political contributions and prohibitions on municipal securities business, imposes a two-year restriction on a dealer, as well as its municipal finance professionals, from seeking municipal securities business from municipal issuers if political contributions prohibited by the rule have been made. Contributions include anything of value used to influence an issuer official. Similar limits on political contributions apply to affiliated and unaffiliated Political Action Committee(s) (PACs) if they are deemed to be controlled by the dealer or one of its municipal finance professionals. The use of PACs to make indirect contributions is prohibited by the rule. Municipal financial professionals may, however, make contributions of up to \$250 to issuer officials for whom they can vote.



MSRB RULE G-37

CONSIDERATIONS:

- Is relevant training provided to the firm's municipal finance professionals and is additional training during election seasons considered.
- How does the firm monitor for political contributions to state legislators who may have the authority to vote on or appoint an individual to a board or governing body with the power to select an underwriter.
- How does the firm monitor for political contributions to issuer officials, including those who are seeking election at the local, state and federal levels.

Failure to Deal Fairly with All Persons in the Conduct of Municipal Securities Activity (MSRB Rule G-17)

MSRB Rule G-17, on conduct of municipal securities and municipal advisory activities, prohibits dealers from engaging in any deceptive, dishonest or unfair practice with respect to its municipal securities activities. In addition, G-17 imposes a fundamental duty of fairness on a dealer with respect to its municipal securities activities, mandating that a dealer deal fairly with all persons, even in the absence of fraud.

The obligation under G-17 applies to a dealer's municipal securities activities with investors as well as other market participants, including municipal entities. For example, a dealer engaged in a negotiated underwriting must disclose conflicts of interest to the municipal securities issuer, that the underwriter's primary role is to purchase securities with a view to distribution in an arms-length transaction and that the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price balanced with its duty to sell municipal securities to investors at prices that are fair and reasonable, among other things.



MSRB RULE G-17

CONSIDERATIONS:

- How does the firm monitor for compliance with fair dealing.
- Does the firm have a process to ensure that it adheres to the priority of orders designated by an issuer.
- How does the firm evidence its due diligence in identifying the material financial risks of a complex transaction and the disclosure of such risks to a municipal entity.
- How does the firm ensure that it discloses its role at the earliest stage of the relationship with a municipal entity, including any potential or actual material conflicts of interest.
- Does the firm have a process to ensure that conflicts that are discovered, or arise, after the firm has been engaged are disclosed to the municipal entity in a timely manner.

Failure to Observe Prohibitions on Underwriting Activities when Engaged in Financial Advisory Activities (MSRB Rule G-23)

MSRB Rule G-23, on activities of financial advisors, is a conflicts rule that prohibits a dealer that has a financial advisory relationship with a municipal entity with respect to the issuance of municipal securities, from acquiring all or any portion of such issue, directly or indirectly, from the issuer as principal, or acting as agent for the issuer in arranging the placement of such issue, either alone or as a participant in a syndicate or other similar account formed for that purpose. A financial advisory relationship shall be deemed to exist when a dealer renders, or enters into an agreement to render, financial advisory or consultant services to or on behalf of a municipal entity with respect to the issuance of municipal securities.

A dealer that clearly identifies itself as an underwriter and not as a financial advisor from the earliest stages of its relationship with the issuer with respect to that issue (e.g. in a response to a request for proposals (RFP)) will be considered to be acting as an underwriter with respect to that issue. If, however, despite identifying itself as an underwriter, a dealer engages in a course of conduct that is inconsistent with an arms-length relationship with the municipal entity in connection with such issue, the dealer will be deemed to be a financial advisor with respect to that issue and precluded from underwriting such issue.



MSRB RULE G-23

CONSIDERATIONS:

- Does the firm have a process to assess whether it has provided, prior to responding to an RFP, financial advisory or consultant services to the municipal entity with respect to the issuance of municipal securities contemplated by the RFP, which would preclude the firm from establishing an underwriting relationship.
- Once the firm provides notice to a municipal entity of its role as an underwriter, how does the firm ensure its conduct remains consistent with an arms-length transaction.
- If a firm is engaged as an underwriter and wants to provide advice on the investment of proceeds of such issue, does it have controls to ensure that, prior to engaging in such activity, it is registered as a municipal advisor or qualifies for an exclusion or exemption.

Failure to Adhere to Restrictions on Gifts, Gratuities and Non-Cash Compensation (MSRB Rule G-20)

MSRB Rule G-20, on gifts, gratuities, non-cash compensation and expenses of issuance, prohibits, with limited exceptions, a dealer from giving or permitting to be given, directly or indirectly, any service or thing of value in excess of \$100 per person per year in relation to the municipal securities activities of the recipient's employer. The rule is designed, in part, to ensure a dealer's municipal securities activities are undertaken in arm's length transactions in which conflicts of interest are minimized and with no attempt to mask the nature of a gift that would otherwise be in direct contravention of the purpose of the rule.

A dealer, with certain exceptions, may not, directly or indirectly, accept or make payments, or offers of payments, of any non-cash compensation in connection with the sale and distribution of a primary offering of municipal securities. As of May 6, 2016, a dealer that engages in municipal securities activities for or on behalf of a municipal entity or obligated person in connection with an offering of municipal securities is prohibited from requesting or obtaining reimbursement from the proceeds of such offering for its costs and expenses related to entertainment expenses not related to ordinary and reasonable expenses for meals hosted by the dealer and directly related to the offering for which the dealer was retained.



MSRB RULE G-20 CONSIDERATIONS:

- How does the firm identify whether gifts have been given or received by its associated persons to ensure that the \$100 per person per year limit is not exceeded, including how associated persons are trained on the requirements to ensure that gifts are not inadvertently excluded.
- Does the firm have a method for properly recording gifts, gratuities and non-cash compensation given and received in accordance with the recordkeeping requirement under MSRB Rule G-8.
- How does the firm monitor its “normal business dealings” activities, as described under Rule G-20, to ensure that such activities are not so frequent or so extensive as to raise a question of propriety.
- Has the firm established a process to monitor that reimbursements for certain entertainment expenses from the proceeds of an offering of municipal securities are not requested or obtained.

Failure to Maintain Adequate Supervisory Procedures (MSRB Rule G-27)

MSRB Rule G-27, on supervision, requires a dealer to supervise the conduct of its municipal securities activities and establish a supervisory system and compliance program reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB rules. A reasonably designed supervisory system would address when the dealer is effecting any transaction in, or inducing or attempting to induce the purchase or sale of, a municipal security. Dealers are reminded that the MSRB has previously noted that a private placement of municipal debt with a single purchaser, including a bank, even if described as a loan, could in fact be a municipal securities transaction and, as a result, require the dealer to comply with the applicable MSRB rules.⁴ In other cases, a direct purchase of a variable rate demand obligation by a bank, followed by a significant restructuring of the terms of the obligation, may amount to a primary offering of municipal securities.

⁴ See MSRB Regulatory Notice 2011-37 “Financial Advisors, Private Placements, and Bank Loans,” (August 3, 2011) and MSRB Notice 2011-52 “Potential Applicability of MSRB Rules to Certain Direct Purchasers and “Bank Loans.” (September 12, 2011).

Dealers sometimes rely on outside service providers to deliver core compliance functions, such as recordkeeping and trade reporting. Engaging unqualified service providers, or failing to manage the relationship vigorously can create compliance failures, including those related to system vulnerabilities and possible cybersecurity threats. In designing a supervisory system, the risks inherent with these relationships should be considered.



MSRB RULE G-27 CONSIDERATIONS:

- Does the firm have a process in place to determine if alternative financings with municipal entities are municipal securities.
- How does the firm implement safeguards and technical controls to protect its data and technology systems from cyber threats.
- Does the firm conduct adequate due diligence in selection, monitoring and oversight of third-party vendors with documentation that clearly delineates the responsibilities with such third-parties.
- How does the firm monitor regulatory developments, including applicable rule changes that might necessitate a change to its written supervisory procedures and/or vendor agreements.

Failure to Observe Professional Qualification Standards (MSRB Rules G-2 and G-3)

MSRB Rule G-2, on standards of professional qualification, provides that no dealer shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any municipal security, and no municipal advisor shall engage in municipal advisory activities, unless such dealer or municipal advisor, and every natural person associated with such dealer or municipal advisor, is qualified in accordance with the rules of the MSRB. While the SEC’s final municipal advisor registration rules provide specific exemptions and exclusions that allow dealers to sell underwriting or other financial services to municipal entities without registration as a municipal advisor,⁵ dealers are reminded to monitor their activity to ensure that appropriate registrations are in place prior to engaging in a new activity.

⁵ See Securities Exchange Act Release No. 70462, (September 20, 2013), 78 FR 67468 (November 12, 2013) (“Securities and Exchange Commission’s Final Municipal Advisor Rules”).

MSRB Rule G-3, on professional qualification requirements, provides that no person associated with a dealer shall be qualified to engage in municipal securities activity unless such person meets the qualification requirements of the rule.

In addition, dealers are required to maintain a continuing education program for certain of their associated persons to ensure that covered persons engaged in municipal securities activity receive training appropriate for the dealer's business, which, at a minimum, must cover general investment features of municipal securities, suitability and sales practice considerations with respect to municipal securities and applicable regulatory requirements.



MSRB RULES G-2 AND G-3 CONSIDERATIONS:

- How does the firm ensure that each of its associated persons involved in municipal securities activities only engages in the specific activities permitted by their registration (e.g., an associated person who passed the General Securities Registered Representative Examination (Series 7) in 2015 is not engaging in underwriting of municipal securities).
- If the firm engages in municipal advisory activities and, in lieu of registering as a municipal advisor, relies on the independent registered municipal advisor (IRMA) exemption, how does the firm evidence that its reliance is reasonable and that the IRMA is meaningfully engaged in the work at hand.
- How does a firm determine which individuals are regularly engaged in municipal securities activities for purposes of developing a written training plan.
- How does the firm evaluate the training provided to covered persons on municipal securities products, services and strategies to confirm that it aligns with the firm's needs analysis and written training plan.

Conclusion

This Advisory is designed to aid dealers in the development of effective policies and procedures for supervision and compliance and the assessment of their compliance programs. In addition to this Advisory, dealers may wish to reference other informational material regarding MSRB rules and regulations on the MSRB's website (www.msrb.org).

The MSRB engages in an ongoing dialog with municipal market participants through outreach events and education activities and encourages dealers to visit the MSRB's website to review past webinars and publications.⁶

⁶ Dealers can also subscribe to MSRB email updates on the MSRB's website to ensure they receive information from the MSRB on upcoming events, educational resources and news in a convenient electronic format.



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