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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2005 - 12
Amendment No.

Proposed Rule Change by Municipal Securities Rulemaking Board

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial	Amendment	Withdrawal	Section 19(b)(2)	Section 19(b)(3)(A)	Section 19(b)(3)(B)
☑	☐	☐	☑	☐	☐

Pilot ☐

Extension of Time Period for Commission Action ☐

Date Expires

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Proposed rule change and Question and Answer guidance concerning Rule G-37, on political contributions and prohibitions on municipal securities business

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name	Carolyn	Last Name	Walsh
Title	Senior Associate General Counsel		
E-mail	cwalsh@msrb.org		
Telephone	(703) 797-6600	Fax	(703) 797-6700

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

Municipal Securities Rulemaking Board

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 06/21/2005

By Ronald W. Smith
(Name)

Corporate Secretary
(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Ronald W. Smith, rsmith@msrb.org

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information

Add Remove View

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

Add Remove View

Exhibit Sent As Paper Document ☐

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

Add Remove View

Exhibit Sent As Paper Document ☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

Add Remove View

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

Add Remove View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) The Municipal Securities Rulemaking Board (the "MSRB") is hereby filing with the Securities and Exchange Commission (the "Commission") a proposed rule change (the "proposed rule change") consisting of an amendment to Rule G-37(c), concerning solicitation and coordination of payments to political parties, and Question and Answer ("Q&A") guidance on supervisory procedures related to Rule G-37(d), on indirect violations. The proposed rule change is set forth below, with brackets indicating deletions and underlining indicating new language.

Rule G-37: Political Contributions and Prohibitions on Municipal Securities Business

(a) – (b) No change.

(c) (i) No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any contribution, or shall coordinate any contributions, to an official of an issuer with which the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

(ii) No broker, dealer or municipal securities dealer or any individual designated as a municipal finance professional of the broker, dealer or municipal securities dealer pursuant to subparagraphs (A), (B), or (C) of paragraph (g)(iv) of this rule shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any payment, or shall coordinate any payments, to a political party of a state or locality where the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

(d) – (j) No change.

Rule G-37 Questions-and-Answers

Q: Is a broker, dealer or municipal securities dealer ("dealer") required to have written supervisory procedures reasonably designed to ensure compliance with Rule G-37(d), on indirect contributions and solicitations, with regard to payments to political parties and PACs by a dealer or its municipal finance professionals ("MFPs")?

A: Yes. The relevant portion of the MSRB's supervision rule, Rule G-27(c), provides that, "Each dealer shall adopt, maintain and enforce written supervisory procedures

reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance [with MSRB rules]."

Rule G-37(d) provides that: "No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall, directly or indirectly, through or by any other person or means, do any act which would result in a violation of sections (b) or (c) of this rule." While Rule G-37 was adopted to deal specifically with contributions made to officials of issuers by dealers and municipal finance professionals, and political action committees ("PACs") controlled by dealers or MFPs, this section of the rule also prohibits MFPs and dealers from using conduits—such as, but not limited to parties, PACs, affiliates, consultants, lawyers or spouses—to contribute indirectly to an issuer official if such MFP or dealer can not give directly to the issuer without triggering the ban on business.

In order to ensure compliance with Rule G-27(c) as it relates to payments to political parties or PACs and Rule G-37(d), each dealer must adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that neither the dealer nor its MFPs are using payments to political parties and non-dealer controlled PACs to contribute indirectly to an official of an issuer.[1] For example, a dealer's written supervisory procedures might provide that, if the dealer or any of its MFPs want to make payments to political parties or PACs, the dealer must perform adequate due diligence **prior** to allowing political party or PAC payments by the dealer or its MFPs to reasonably ensure that neither the dealer nor its MFPs are using payments to political parties or non-dealer controlled PACs to contribute indirectly to an official of an issuer.[2] Such due diligence also might include inquiring about and documenting the intent or motive in making the payment, whether the party payment or PAC contribution was solicited by anyone, and if so, the identification of the person soliciting the party payment and a record of written solicitations. This information will assist the dealer in determining whether the facts and circumstances surrounding the payment support the reason given for making the payment.

In addition, to ensure compliance with Rule G-37(d) in connection with contributions by dealers or MFPs to non-controlled (but affiliated) PACs,[3] the dealer might adopt information barriers between any affiliated PACs and the dealer or its MFPs. Examples of such information barrier provisions might include such things as:

- a prohibition on the dealer or MFPs from recommending, nominating, appointing or approving the management of affiliated PACs;
- a prohibition on sharing the affiliated PAC's meeting agenda, meeting schedule, or meeting minutes;
- a prohibition on identification of prior affiliated PAC contributions, planned PAC contributions or anticipated PAC contributions;
- a prohibition on directly providing or coordinating information about prior negotiated municipal securities business, solicited municipal securities business, and planned solicitations of municipal securities business; and

- other such information barriers as the firm deems appropriate to effectively monitor conflicting interests and prevent abuses.

These examples are not exclusive and are only suggestions for supervisory procedures that dealers could consider. Each dealer is required under Rule G-27, on supervision, to evaluate its own circumstances and develop written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance with Rule G-37, on indirect violations.

Q: Is a dealer required to have written supervisory procedures in place to ensure compliance with Rule G-37(d) if the dealer only allows the dealer or its municipal finance professionals ("MFPs") to make political party payments to "housekeeping", "conference" or "overhead" type accounts of a political party?

A: Yes. There is no safe harbor under Rule G-37 for payments to "housekeeping", "conference" or "overhead" type political party accounts. The dealer must have adequate supervisory procedures reasonably designed to prevent a violation of Rule G-37(d), on indirect political contributions, even when the payments are being made to a "housekeeping", "conference" or "overhead" type account. While the political party itself may prohibit direct contributions to issuer official candidates from "housekeeping" accounts, payments to these accounts might be used for political party events that are focused to benefit a specific candidate or a small number of candidates. Additionally, because money is fungible, a payment made to a fund earmarked for non-issuer official elections might "free up" other money to support the candidacy of specific issuer officials.

The need for dealers to adopt adequate written supervisory procedures to prevent indirect violations via "housekeeping", "conference" or "overhead" type political party accounts is especially important in light of media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to an affiliated party's "housekeeping" account. In addition, NASD staff has informed the MSRB that some firms make contributions to "housekeeping" accounts or PAC's with explicit instructions accompanying the payment that the specific payment is not to be used for the benefit of one or a limited number of issuer officials. The MSRB does not consider such "preemptive" disclosures or instructions sufficient to meet the dealer's obligation to perform due diligence to reasonably ensure that the payment to the political party or PAC is not being made to circumvent the requirements of Rule G-37.

[1] In addition, pursuant to MSRB Rule G-8(a)(xx), on Records Concerning Compliance with Rule G-27, each dealer must maintain and keep current the records required under Rules G-27(c) and G-27 (d).

[2] *See* Rule G-37 Questions and Answers Nos. III. 4 and III.5, *reprinted in* MSRB Rule Book.

[3] For the purposes of this guidance the term "affiliated PAC" means a PAC controlled by an affiliated entity of a dealer. An "affiliated entity" is an entity that controls, is controlled by or is under common control with the dealer.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The MSRB adopted the proposed rule change at its May 11-12, 2005 Board meeting. Questions concerning this filing may be directed to Carolyn Walsh, Senior Associate General Counsel, at (703) 797-6600.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Rule G-37(c) prohibits a dealer and its municipal finance professionals ("MFPs") from soliciting any person or political action committee ("PAC") to make or coordinate contributions to an official of an issuer with which the dealer is engaging or is seeking to engage in municipal securities business. The proposed amendments would also prohibit the dealer and certain MFPs[1] from soliciting any person or PAC to make or coordinate a payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business.[2] The proposed rule

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[1] The proposed amendment limits MFPs who would be prohibited from soliciting or coordinating political party payments to those persons who are directly involved in the dealer's municipal securities business. The proposed language provides that only MFPs who are primarily engaged in municipal representative activities, solicitors of municipal securities business, or direct supervisors of MFPs that are "solicitors" or "primarily engaged" are prohibited from soliciting political party payments. The MSRB limited those MFPs covered by the proposed amendments to those directly involved in the municipal securities business of the dealer; recognizing that other MFPs more distant from the day-to-day operations of the dealer's municipal securities business may have other reasons to solicit or coordinate payments to political parties (*i.e.*, reasons related to other business activities of the dealer).

[2] The MSRB notes that, depending upon the facts and circumstances, an MFP's solicitation of a contribution to an issuer with which the dealer is engaging or is seeking to engage in municipal securities business or the solicitation of a political party payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business, may also constitute a violation of Rule G-37(d), on indirect violations.

amendments would specifically define any "person"[3] to include any affiliated entity of the dealer. This clarification is intended to alert dealers and MFPs that influencing the disbursement decisions of affiliated entities or PACs may constitute a direct violation of Rule G-37(c), as amended, if the dealer or MFP solicits the affiliated entity or PAC to make or coordinate contributions to an official of an issuer or a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business. Accordingly, in order to ensure compliance with Rule G-37(c), dealers should consider the adequacy of their information barriers with affiliated entities, or PACs controlled by affiliated entities, to ensure that the affiliated entities' contributions, payments, or PAC disbursement decisions are neither influenced by the dealer or its MFPs, nor communicated to its MFPs.

The proposed Q&A guidance provides that, in order to ensure compliance with Rule G-27(c) as it relates to payments to political parties or PACs and Rule G-37(d), each dealer must adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that neither the dealer nor its MFPs are using payments to political parties and non-dealer controlled PACs to contribute indirectly to an official of an issuer.[4] The draft Q&A guidance also explicitly states that contributing to "housekeeping", "conference" or "overhead" type accounts is not a safe harbor and does not alleviate the dealer's supervisory obligation to conduct this due diligence.

The Qs&As seek to provide dealers with more guidance as they develop procedures to ensure compliance with both the language and the spirit of Rule G-37. The Qs&As emphasize the necessity for adequate supervisory procedures to ensure compliance with Rule G-37(d) not only with respect to payments to political parties, but also with respect to contributions to and disbursements by dealer-affiliated (but not controlled) PACs. The Board reminds dealers that a failure to implement satisfactory written procedures to ensure compliance with Rule G-37(d) could subject the dealer to enforcement actions by the appropriate regulatory authorities.

(b) The MSRB has adopted the proposed rule change pursuant to Section 15B(b)(2)(C) of the Exchange Act, as amended (the "Exchange Act"), which requires that the rules of the MSRB shall:

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating…transactions in municipal securities, to remove

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[3] "Person" is defined in § 3(9) of the Act, to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Unless the context otherwise specifically requires, the terms used in MSRB rules have the meanings set forth in the Act. *See* MSRB Rule D-1.

[4] In addition, pursuant to MSRB Rule G-8(a)(xx), on records concerning compliance with Rule G-27, each dealer must maintain and keep current the records required under Rules G-27(c) and G-27 (d).

impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.

The MSRB believes that the proposed rule change is consistent with the Exchange Act because it will help inhibit practices that create the appearance of attempting to influence the awarding of municipal securities business through an indirect violation of Rule G-37. The MSRB also believes that the Q&A guidance will facilitate dealer compliance with Rule G-27, on supervision, and Rule G-37(d)'s prohibitions on indirect rule violations.

4. Self-Regulatory Organization's Statement on Burden on Competition

The MSRB does not believe the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act because it applies equally to all dealers in municipal securities.

5. Self-Regulatory Organization's Statement on Comments Received on the Proposed Rule Change by Members, Participants, or Others

On February 15, 2005 the MSRB published for industry comment draft amendments to Rule G-37(c), concerning solicitation and coordination of payments to political parties, and draft Q&A guidance on supervisory procedures related to Rule G-37(d), on indirect violations (the "Notice").[5] The MSRB received seven comments on the Notice.[6]

Of the seven commentators, one commentator, American Municipal, supports the adoption of the amendments to Rule G-37 and the proposed Qs&As because they will strengthen the effectiveness of the rule in preventing improper political contributions.[7] One commentator, Griffin, Kubik, believes that the existing structure of Rule G-37 is

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5 *See* MSRB Notice 2005-11 (February 15, 2005).

6 The Board received comment letters from the following: Sarah A. Miller, General Counsel, ABASA Securities Association ("ABASA") to Carolyn Walsh, Senior Associate General Counsel MSRB, dated April 11, 2005; J. Cooper Petagna, Jr., President, American Municipal Securities, Inc. ("American Municipal") to Ms. Walsh, dated March 10, 2005; Robert E. Foran, Senior Managing Director, Bear Stearns & Co., Inc. ("Bear Stearns") to Ms. Walsh, dated March 31, 2005; Leslie M. Norwood, Vice-President and Assistant General Counsel, Bond Market Association ("BMA") to Ms. Walsh, dated April 1, 2005; Robert J. Stracks, Counsel, Griffin, Kubik, Stephens & Thompson, Inc. ("Griffin, Kubik") to Ms. Walsh, dated March 30, 2005; Marc E. Lackritz, President, Securities Industry Association ("SIA") to Ms. Walsh, dated April 5, 2005; and Terry L. Atkinson, Managing Director, UBS Financial Services Inc. ("UBS") to Ms. Walsh, dated April 1, 2005.

7 American Municipal also suggests that consideration be given to having the rule applied to all registered personnel and not just MFPs.

unconstitutional and complains about the existing operation of Rule G-37.[8] Griffin, Kubik also suggests that requiring full and immediate disclosure of dealer contributions by the recipient issuer official would be more effective in policing this arena.

The remaining five commentators express support for the MSRB's efforts to eliminate any vestiges of pay-to-play in the municipal securities industry, whether they are in the form of a direct or indirect contribution to an issuer official. However, ABASA, BMA[9], SIA and UBS assert that the Qs&As are vague thus making it impossible for broker-dealers to know exactly what standard to apply. ABASA, BMA, SIA and UBS request that the MSRB clarify the proposed Qs&As as they relate to contributions to party committees and PACs so that they establish clear standards upon which the industry may rely. BMA, SIA and UBS request that the MSRB expressly state that contributions made to national party committees and certain federal leadership PACs (controlled by members of Congress) are permitted. BMA and UBS also request that the MSRB: (1) acknowledge that the proposed Qs&As reflect a new approach to Rule G-37's prohibition on indirect contributions and not just a restatement of the existing standard; (2) modify the prohibition on soliciting contributions to state or local parties so that broker-dealers and MFPs would be permitted to solicit contributions to the same extent they are able to make a contribution to them; and (3) clarify what is meant by "affiliated PAC" for purposes of erecting an informational barrier.[10] ABASA also states that the MSRB's suggested information barrier concerning past and current municipal securities business is unrealistic because much of the information is public. These specific comments are discussed in detail below.

The Draft Amendments to Rule G-37(c)(ii): The Prohibition on Soliciting Contributions to State and Local Party Committees Should be Symmetrical to the Contributions Ban.

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8 This commentator complains that if an associated person of a dealer introduces or solicits municipal securities business for the dealer while at the same time making political contributions to an official of a completely different local political body, the broker-dealer could face a G-37 compliance problem. In fact, assuming this was the first time the associated person solicited municipal securities business for the dealer, the contribution to an issuer official who is not the issuer official solicited would not result in a ban on doing business with the introduced issuer. It would, however, result in the associated person becoming a municipal finance professional of the dealer and being subject to Rule G-37 from the date of the solicitation activity forward.

9 Because the Bear Stearns comment letter simply states that it supports the BMA letter, for the purposes of this discussion Bear Stearns' positions will not be separately identified. Rather, it should be understood that positions attributed to BMA are also supported by Bear Stearns.

10 Griffin, Kubik also seeks this clarification.

Comments Received. BMA and UBS assert that the Rule G-37(c) amendment should be symmetrical to the contributions ban because they do not believe it makes sense to impose a greater, absolute prohibition on soliciting contributions than on making contributions. BMA recommends that dealers and MFPs be permitted to solicit contributions to the same extent they are allowed to make contributions.

MSRB Response. The proposed rule amendment is more limited than what the comment letters portray. The comment letters state that the amendment would completely prohibit MFPs from soliciting contributions to any state and local party committees when, in fact, it only prohibits solicitations by the dealer or certain MFPs for contributions to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business. Thus, the proposed amendment is narrowly tailored to regulate only a dealer's or certain MFP's solicitation of other persons' payments to political parties when there can be a perception that MFPs and dealers are soliciting others to make payments to parties or PACs as an end-run around the rule and the rule's disclosure requirements.

Current Rule G-37(c) operates as an absolute prohibition on soliciting contributions for an official of an issuer with which the dealer is engaging or seeking to engage in municipal securities business and is not symmetrical with Rule G-37(b) because there is no *de minimus* exception in Rule G-37(c). Moreover, because dealers' and MFPs' payments to political parties do not trigger the automatic ban on business (unless there is an indirect violation) there is no mechanism to correlate the party payment disclosure scheme in Rule G-37 with the proposed prohibition on the solicitation and coordination of payments to political parties of states or localities where the dealer is engaging or seeking to engage in municipal securities business.

The MSRB determined that allowing dealers or certain MFPs to solicit other persons to make political party or PAC payments in states and localities where they are engaging or seeking to engage in municipal securities business creates at least the appearance of attempting to influence the awarding of municipal securities business through such payments. Moreover, without the proposed prohibition, it would be very difficult for enforcement agencies to detect such potential indirect violations because the parties solicited do not have to disclose the payments. Additionally, the arguably stricter prohibition can be justified because a violation of Rule G-37(c) does not result in an automatic ban on business.

Vagueness of the Proposed Q&A Guidance Concerning Rule G-27, on Supervision, and Rule G-37(d), on Indirect Violations.

Comments Received. ABASA, BMA, SIA, and UBS request that the Qs&As be clarified because they do not present a clear objective standard as to when party and PAC contributions should be treated as indirect contributions to issuer candidates. BMA, SIA and UBS also complain that the Qs&As represent an expansion of Rule G-37. BMA suggests that if the MSRB's intent is to absolutely eliminate state and local party committee and PAC contributions, it should come out with a clear prohibition.

MSRB Response. The MSRB's intent was *not* to eliminate all state and local party committee and PAC contributions or to specify which ones would not be indirect contributions to issuer officials. The MSRB recognizes that some payments to political parties are made for reasons that have no connection with influencing the awarding of municipal securities business. The MSRB's decision to issue the proposed Q&A guidance was prompted by concern that dealers are not implementing adequate supervisory procedures reasonably designed to prevent indirect rule violations. The MSRB also voiced its concern about the emergence of recent media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to the affiliated party's "housekeeping" account.

By voicing a concern that dealers who make such payments to parties or PACs *may* be doing so in an effort to avoid the political contribution limitations embodied in Rule G-37, the MSRB was not expanding the reach of Rule G-37. The MSRB was, however, alerting dealers to modern day political realities and practices that may prove—with hindsight—to be problematic. The MSRB was also suggesting, though not requiring, general supervisory procedures designed to help ensure that the party or PAC payments do not result in a violation of Rule G-37(d). Dealers are required to implement adequate supervisory procedures, but the MSRB's suggestions about general approaches to conducting adequate due diligence are not meant to be either required procedures or a safe harbor. Ideally, an adequate supervisory procedure will prevent a Rule G-37(d) violation, but the existence of adequate supervisory procedures may only protect the firm from a resulting Rule G-27 violation should a problem later occur. A payment permitted by the dealer's supervisory procedures may still result in a violation of Rule G-37(d) if it is later proven that the MFP in question contributed with the intent to circumvent the rule. Such instance, of course, could put the dealer in a good position to seek a waiver of the resulting ban on business from the NASD.

Moreover, the proposed Qs&As do not broaden the sphere of activity that is prohibited by Rule G-37. A violation of Rule G-37(d) still will only occur when the payment is made to other entities "as a means to circumvent the rule." Rule G-37(d), which prohibits anyone from "directly or indirectly, through or by any other person or means" doing what sections (b) and (c) prohibit has previously been challenged on the grounds that it is unconstitutionally vague. The United States Court of Appeals in *Blount v. SEC*[11] rejected this challenge 10 years ago. In *Blount,* the Court stated,

> Although the language of section (d) itself is very broad, the SEC has interpreted it as requiring a showing of culpable intent, that is, a demonstration that the conduct was undertaken "as a means to circumvent" the requirements of (b) and (c). . . . The SEC states its "means to circumvent" qualification in general terms. The qualification appears, therefore, to apply not only to such items as

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[11] *Blount v. SEC*, 61 F.3d 938, (D.C. Cir. 1995), *rehearing and suggestion for rehearing en banc denied* (1995), *certiorari denied by* 517 U.S. 1119, 116 S.Ct. 1351, 134 L.Ed.2d 520 (1996).

> contributions made by the broker's or dealer's family members or employees, but also gifts by a broker to a state or national party committee, made with the knowledge that some part of the gift is likely to be transmitted to an official excluded by Rule G-37. In short, according to the SEC, the rule restricts such gifts and contributions only when they are intended as end-runs around the direct contribution limitations.[12]

The Standards in the "Reasons Test" and "Activity Test" Need to be Clarified.

Comments Received. ABASA, BMA, SIA and UBS assert that the proposed Q&A guidance should be clarified with bright-line tests to identify the parties or PACs to which dealers and MFPs can make payments without violating Rule G-37(d), on indirect violations. In particular, the commentators object to the guidance that suggests that the dealer identify the reason for making the payment to the party or PAC (the "reasons test") without defining the motivation(s) that should result in a contribution being classified as an indirect contribution to an issuer official. BMA suggests that the reasons test be clarified to only cover contributions to party committees and PACs that are controlled by, or where the contribution is solicited by, an issuer official.

The commentators also object to the suggestion that dealers make inquiries to essentially "follow the money" to reasonably ensure that the party or PAC is not supporting one or a limited number of issuer officials (the "activity test") on the grounds that it is unclear. BMA asserts that the language is unclear because it could mean one of two things: (1) if the party or PAC that receives the contribution supports even one issuer official, then an indirect ban is triggered; or (2) the dealer must determine that the party's or PAC's expenditures on issuer officials constitute a large enough portion of its total expenditures such that an indirect ban is triggered. BMA and UBS ask the MSRB to revise its guidance to suggest a test based on objective criteria. UBS suggests that this objective criteria include a "dilution standard" that would need to include at least the following elements: (1) a threshold—50%, 60% or 70% --of a party's or PAC's expenditures used for non-issuer purposes that would be sufficient to overcome a presumption that the committee supported one or a limited number of issuer officials, and (2) a time period over which the party committee or PAC would be required to examine when calculating the threshold percentage.

MSRB Response. As discussed above, the proposed Q&A guidance does not change the existing legal framework concerning the motivation that would result in a contribution being classified as an indirect contribution to an issuer official. An MFP or dealer could be found (after the fact) to have violated Rule G-37(d) if payments to a party or PAC are intended as end-runs around the direct contribution limitations. The MSRB does not believe it is appropriate to attempt to delineate specific reasons that are permissible, and those that are not. What is important is that dealers institute adequate procedures to identify potential violations. If the dealer's procedures include making an

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12 *Id* at 948.

inquiry about the reason for making the payment[13] the dealer must then exercise its judgment as to whether the facts and circumstances surrounding the payment indicate that the reason for making the contribution was to circumvent Rule G-37.

With regard to the "activity test" comments, the MSRB's existing Q&A guidance on this issue already states that dealers that make contributions to organizations such as political parties or PACs (as well as dealers that allow MFPs to make such payments) have a duty to make inquiries of such organizations in order to ascertain how the contributed funds will be used.[14] Following this guidance, dealers should be able to develop adequate written supervisory procedures reasonably designed to ensure that payments to political parties or PACs are not being used to circumvent the requirements of Rule G-37. The MSRB does not believe it is useful to provide "safe harbors" concerning parties or PACs such that a dealer or MFP could make payments to certain parties or PACs without investigating whether the payment is actually being made as a means to circumvent the requirements of Rule G-37. Such "safe harbors" create the potential for loopholes in Rule G-37's regulatory scheme as parties and PACs tailor their solicitations for contributions to MSRB suggested parameters.

However, the MSRB has determined to revise the guidance and remove some of the specific due diligence suggestions to focus on reminding dealers that each dealer is required under Rule G-27, on supervision, to evaluate its own circumstances and develop written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance with Rule G-37(d), on indirect violations. After evaluating it's own circumstances, a dealer could determine that adequate supervisory procedures would include some of the commentators' suggested due diligence procedures.

National Party Committees and Federal Leadership PACs Should be Expressly Permitted.

Comments Received. BMA, SIA and UBS request that, while they believe contributions to national party committees and federal leadership PACs appear to be permitted under the due diligence standards established by the proposed Qs&As, the MSRB should expressly state that contributions made to a national party committee or federal leadership PAC are permitted under the proposed Qs&As as long as (1) the

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13 To the extent that dealers are concerned that the act of inquiring about persons' reasons for making payments to PACs and political partiers may chill political speech, the procedure could require persons to give negative assurances that the party or PAC payment is not being made as a means to circumvent the requirements of Rule G-37.

14 *See* Rule G-37 Questions and Answers No. III. 5, *reprinted in* MSRB Rule Book. *See also* Rule G-37 Questions and Answers Nos. III.3 and III.4, *reprinted in* MSRB Rule Book.

contribution was not solicited by an issuer official, and (2) the party committee or leadership PAC is not controlled by an issuer official.

MSRB Response. Essentially, the commentators are asking the MSRB to create a safe harbor for certain national party committees and federal leadership PACs. The creation of such a safe harbor would be a departure from the intended reach of Rule G-37(d). As noted above, the Court of Appeals in *Blount* expressly recognized that Rule G-37 (d) was originally intended to prevent payments to both *national* and state parties used as a "means to circumvent" Rule G-37. Moreover, although BMA, SIA and UBS essentially assert that when a contribution is not solicited by an issuer official and the party leadership PAC is not controlled by an issuer official the national party committees and federal leadership PACs can not be used as a means to circumvent Rule G-37, such a position is inconsistent with public perception.[15] Additionally, the Supreme Court's recent decision in *McConnell v. Federal Election Commission,*[16] emphasized the potential for payments to a political party to have undue influence on the actions of the elected officeholders belonging to the same party. *McConnell* upheld new federal statutory restrictions on soft money donations that were neither solicited by candidates nor used by the party to aid specific candidates. Given public perception and the Supreme Court's pronouncements, the MSRB believes it is reasonable to require dealers to be responsible for having adequate supervisory procedures that obligate the dealer to exercise its judgment concerning whether contributions to any party or PAC are being made as a means to circumvent the provisions of Rule G-37.

The Existence of a "Safe-Harbor" For Payments to "Housekeeping" Or "Conference" Accounts

Comments Received. The BMA and UBS assert that the MSRB's statements in the Notice are a departure from prior statements because previously the MSRB recognized a "safe-harbor" that expressly permitted contributions to "conference accounts" of state and local party committees. ABASA also states that the MSRB has with the draft Qs&As, in effect, outlawed contributions to housekeeping and similar accounts.

MSRB Response. The MSRB's statements in the Notice about the status of "housekeeping" or "conference" type accounts were made to correct a misconception about these types of accounts. Although the MSRB never recognized such accounts as a

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15 *See e.g.,* Spina, Naples favors one underwriter GOP backer gets 80% of county bond business, even at $500,000 higher cost, *The Buffalo News, April 6, 2005* at p. A1 (suggesting that an MFP's contributions to a PAC run by House Majority Leader Tom Delay were transferred to the congressional campaign of a sitting issuer official that awarded 14 of 24 bond deals to firms that the MFP was associated with).

16 *McConnell v. Federal Election Commission,* 540 U.S. 93, 124 S.Ct. 619 (Dec. 10, 2003).

safe-harbor, the MSRB learned that some dealers might have believed that payments to a "housekeeping" type account could not result in an indirect violation of Rule G-37. The SEC's approval order of certain early amendments to Rule G-37 demonstrates that the MSRB never intended for dealers to treat payments to administrative accounts as a safe harbor.[17]

In 1995, the MSRB filed and the SEC approved amendments to Rule G-37's disclosure requirements to require dealers to record and report all *payments* to parties by dealers, PACs, MFPs and executive officers regardless of whether those payments constitute *contributions*. In the 1995 SEC Approval Order, the SEC reiterated that the party payment disclosure requirements are intended to help ensure that dealers do not circumvent the prohibition on business in the rule by indirect contributions to issuer officials through payments to political parties. The SEC explained that the need for the language amendment was motivated by attempts by dealers and/or political parties to assert that contributions to administrative type accounts did not fall within the rule's regulatory ambit. In the 1995 SEC Approval Order, the SEC states:

> Certain dealers and other industry participants have notified the MSRB that certain political parties currently are engaging in fundraising practices which, according to these political parties, do not invoke the application of rule G-37. For example, some of these entities currently are urging dealers to make payments to political parties earmarked for expenses other than political contributions (such as administrative expenses or voter registration drives). Since these payments would not constitute "contributions" under the rule, the recordkeeping and reporting provisions would not apply. The MSRB is concerned, based upon this information, that the same pay-to-play pressures that motivated the MSRB to adopt rule G-37 may be emerging in connection with the fundraising practices of certain political parties described above.[18]

In addition, in August 2003, when the MSRB published a notice on indirect rule violations of Rule G-37, the MSRB referenced the 1995 SEC Approval Order and specifically stated that, "The party payment disclosure requirements were intended to assist in severing any connection between payments to political parties (*even if earmarked for expenses other than political contributions*) and the awarding of municipal securities business."[19]

The Term Affiliated PAC should be Clarified.

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17 *See* Securities and Exchange Act Release No. 35446 (SEC Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Rule G-37 on Political Contributions and Prohibitions on Municipal Securities Business, and Rule G-8, on Recordkeeping) (March 6, 1995) ("1995 SEC Approval Order").

18 *Id.* at p.7.

19 MSRB Notice 2003-32 (August 6, 2003) at pp. 1-2 (emphasis added).

The BMA states that, while the proposed Qs&As suggest that a broker-dealer establish an informational barrier between it and its affiliated PAC, the MSRB does not clarify what it means by the term "affiliated PAC." The BMA also states that the MSRB should clarify "affiliated PAC" to mean a PAC that is controlled by a wholly owned affiliate of the broker-dealer.

MSRB Response. The MSRB has accepted the suggestion that the term "affiliated PAC" should be defined in the guidance and has revised the guidance to provide that for the purposes of this guidance the term "affiliated PAC" means a PAC controlled by an affiliated entity of a dealer. An "affiliated entity" is an entity that controls, is controlled by or is under common control with the dealer. This use of the term "affiliated" is consistent with the use of the term in the MSRB's proposed amendments to Rule G-38(b)(ii), on consultants.[20]

Recommendations Concerning Information Barriers.

Comments Received. ABASA states that the MSRB's suggestion that dealers establish an information barrier prohibiting sharing information about prior negotiated municipal securities business as well as current and planned solicitations between the dealer, its MFPs and any affiliated PAC is unrealistic because much of the information is public.

MSRB Response. The MSRB has revised the language relating to the municipal securities business information barrier to suggest that dealers prohibit the dealer and its MFPs from directly providing or coordinating information about prior negotiated municipal securities business as well as current and planned solicitations to any affiliated PAC.

6. Extension of Time Period for Commission Action

The MSRB declines to consent to an extension of the time period specified in Section 19(b)(2) of the Exchange Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

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[20] *See* File No. SR-MSRB-2005-04.

9. Exhibits

1. Federal Register Notice.

2. MSRB Notice 2005-11 (February 15, 2005) and comment letters.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-MSRB-2005-12)

SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by the Municipal Securities Rulemaking Board Concerning Solicitation and Coordination of Payments to Political Parties, and Question and Answer Guidance on Supervisory Procedures Related to Rule G-37(d), on Indirect Violations

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b)(1) (the "Act"), notice is hereby given that on June 21, 2005, the Municipal Securities Rulemaking Board (the "MSRB") filed with the Securities and Exchange Commission (the "SEC" or "Commission") a proposed rule change (the "proposed rule change") as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

The MSRB is filing with the SEC a proposed rule change consisting of an amendment to Rule G-37(c), concerning solicitation and coordination of payments to political parties, and Q&A guidance on supervisory procedures related to Rule G-37(d), on indirect violations. The proposed rule change is set forth below, with brackets indicating deletions and underlining indicating new language:

Rule G-37: Political Contributions and Prohibitions on Municipal Securities Business

(a) – (b) No change.

(c) (i) No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any contribution, or shall coordinate any contributions, to an official of an issuer with which the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

(ii) No broker, dealer or municipal securities dealer or any individual designated as a municipal finance professional of the broker, dealer or municipal securities dealer pursuant to subparagraphs (A), (B), or (C) of paragraph (g)(iv) of this rule shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any payment, or shall coordinate any payments, to a political party of a state or locality where the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

(d) – (j) No change.

Rule G-37 Questions-and-Answers

Q: Is a broker, dealer or municipal securities dealer ("dealer") required to have written supervisory procedures reasonably designed to ensure compliance with Rule G-37(d), on indirect contributions and solicitations, with regard to payments to political parties and PACs by a dealer or its municipal finance professionals ("MFPs")?

A: Yes. The relevant portion of the MSRB's supervision rule, Rule G-27(c), provides that, "Each dealer shall adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance [with MSRB rules]."

Rule G-37(d) provides that: "No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall, directly or indirectly, through or by any other person or means, do any act which would result in a violation of sections (b) or (c) of this rule." While Rule G-37 was adopted to deal specifically with contributions made to officials of issuers by dealers and municipal finance professionals, and political action committees ("PACs") controlled by dealers or MFPs, this section of the rule also prohibits MFPs and dealers from using conduits—such as, but not limited to parties, PACs, affiliates, consultants, lawyers or spouses—to contribute indirectly to an issuer official if such MFP or dealer can not give directly to the issuer without triggering the ban on business.

In order to ensure compliance with Rule G-27(c) as it relates to payments to political parties or PACs and Rule G-37(d), each dealer must adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that neither the dealer nor its MFPs are using payments to political parties and non-dealer controlled PACs to contribute indirectly to an official of an issuer.[1] For example, a dealer's written supervisory procedures might provide that, if the dealer or any of its MFPs want to make payments to political parties or PACs, the dealer must perform adequate due diligence **prior** to allowing political party or PAC payments by the dealer or its MFPs to reasonably ensure that neither the dealer nor its MFPs are using payments to political parties or non-dealer controlled PACs to contribute indirectly to an official of an issuer.[2] Such due diligence also might include inquiring about and documenting the intent or motive in making the payment, whether the party payment or PAC contribution was solicited by anyone, and if so, the identification of the person soliciting the party payment and a record of written solicitations. This information will assist the dealer in determining whether the facts and circumstances surrounding the payment support the reason given for making the payment.

In addition, to ensure compliance with Rule G-37(d) in connection with contributions by dealers or MFPs to non-controlled (but affiliated) PACs,[3] the dealer might adopt information barriers between any affiliated PACs and the dealer or its MFPs. Examples of such information barrier provisions might include such things as:

- a prohibition on the dealer or MFPs from recommending, nominating, appointing or approving the management of affiliated PACs;
- a prohibition on sharing the affiliated PAC's meeting agenda, meeting schedule, or meeting minutes;
- a prohibition on identification of prior affiliated PAC contributions, planned PAC contributions or anticipated PAC contributions;
- a prohibition on directly providing or coordinating information about prior negotiated municipal securities business, solicited municipal securities business, and planned solicitations of municipal securities business; and
- other such information barriers as the firm deems appropriate to effectively monitor conflicting interests and prevent abuses.

These examples are not exclusive and are only suggestions for supervisory procedures that dealers could consider. Each dealer is required under Rule G-27, on supervision, to evaluate its own circumstances and develop written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance with Rule G-37, on indirect violations.

Q: Is a dealer required to have written supervisory procedures in place to ensure compliance with Rule G-37(d) if the dealer only allows the dealer or its municipal

finance professionals ("MFPs") to make political party payments to "housekeeping", "conference" or "overhead" type accounts of a political party?

A: Yes. There is no safe harbor under Rule G-37 for payments to "housekeeping", "conference" or "overhead" type political party accounts. The dealer must have adequate supervisory procedures reasonably designed to prevent a violation of Rule G-37(d), on indirect political contributions, even when the payments are being made to a "housekeeping", "conference" or "overhead" type account. While the political party itself may prohibit direct contributions to issuer official candidates from "housekeeping" accounts, payments to these accounts might be used for political party events that are focused to benefit a specific candidate or a small number of candidates. Additionally, because money is fungible, a payment made to a fund earmarked for non-issuer official elections might "free up" other money to support the candidacy of specific issuer officials.

The need for dealers to adopt adequate written supervisory procedures to prevent indirect violations via "housekeeping", "conference" or "overhead" type political party accounts is especially important in light of media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to an affiliated party's "housekeeping" account. In addition, NASD staff has informed the MSRB that some firms make contributions to "housekeeping" accounts or PAC's with explicit instructions accompanying the payment that the specific payment is not to be used for the benefit of one or a limited number of issuer officials. The MSRB does not consider such "preemptive" disclosures or instructions sufficient to meet the dealer's obligation to perform due diligence to reasonably ensure that the payment to the political party or PAC is not being made to circumvent the requirements of Rule G-37.

[1] In addition, pursuant to MSRB Rule G-8(a)(xx), on Records Concerning Compliance with Rule G-27, each dealer must maintain and keep current the records required under Rules G-27(c) and G-27 (d).

[2] *See* Rule G-37 Questions and Answers Nos. III. 4 and III.5, *reprinted in* MSRB Rule Book.

[3] For the purposes of this guidance the term "affiliated PAC" means a PAC controlled by an affiliated entity of a dealer. An "affiliated entity" is an entity that controls, is controlled by or is under common control with the dealer.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, the MSRB included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Rule G-37(c) prohibits a dealer and its municipal finance professionals ("MFPs") from soliciting any person or political action committee ("PAC") to make or coordinate contributions to an official of an issuer with which the dealer is engaging or is seeking to engage in municipal securities business. The proposed amendments would also prohibit the dealer and certain MFPs[1] from soliciting any person or PAC to make or coordinate a payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business.[2] The proposed rule amendments

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[1] The proposed amendment limits MFPs who would be prohibited from soliciting or coordinating political party payments to those persons who are directly involved in the dealer's municipal securities business. The proposed language provides that only MFPs who are primarily engaged in municipal representative activities, solicitors of municipal securities business, or direct supervisors of MFPs that are "solicitors" or "primarily engaged" are prohibited from soliciting political party payments. The MSRB limited those MFPs covered by the proposed amendments to those directly involved in the municipal securities business of the dealer; recognizing that other MFPs more distant from the day-to-day operations of the dealer's municipal securities business may have other reasons to solicit or coordinate payments to political parties (*i.e.*, reasons related to other business activities of the dealer).

[2] The MSRB notes that, depending upon the facts and circumstances, an MFP's solicitation of a contribution to an issuer with which the dealer is engaging or is seeking to engage in municipal securities business or the solicitation of a political

would specifically define any "person"[3] to include any affiliated entity of the dealer. This clarification is intended to alert dealers and MFPs that influencing the disbursement decisions of affiliated entities or PACs may constitute a direct violation of Rule G-37(c), as amended, if the dealer or MFP solicits the affiliated entity or PAC to make or coordinate contributions to an official of an issuer or a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business. Accordingly, in order to ensure compliance with Rule G-37(c), dealers should consider the adequacy of their information barriers with affiliated entities, or PACs controlled by affiliated entities, to ensure that the affiliated entities' contributions, payments, or PAC disbursement decisions are neither influenced by the dealer or its MFPs, nor communicated to its MFPs.

The proposed Q&A guidance provides that, in order to ensure compliance with Rule G-27(c) as it relates to payments to political parties or PACs and Rule G-37(d), each dealer must adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that neither the dealer nor its MFPs are using payments to political parties and non-dealer controlled PACs to contribute indirectly to an official of an issuer.[4] The draft Q&A guidance also explicitly states that contributing to "housekeeping",

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party payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business, may also constitute a violation of Rule G-37(d), on indirect violations.

3 "Person" is defined in § 3(9) of the Act, to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Unless the context otherwise specifically requires, the terms used in MSRB rules have the meanings set forth in the Act. *See* MSRB Rule D-1.

4 In addition, pursuant to MSRB Rule G-8(a)(xx), on records concerning compliance with Rule G-27, each dealer must maintain and keep current the records required under Rules G-27(c) and G-27 (d).

"conference" or "overhead" type accounts is not a safe harbor and does not alleviate the dealer's supervisory obligation to conduct this due diligence.

The Qs&As seek to provide dealers with more guidance as they develop procedures to ensure compliance with both the language and the spirit of Rule G-37. The Qs&As emphasize the necessity for adequate supervisory procedures to ensure compliance with Rule G-37(d) not only with respect to payments to political parties, but also with respect to contributions to and disbursements by dealer-affiliated (but not controlled) PACs. The Board reminds dealers that a failure to implement satisfactory written procedures to ensure compliance with Rule G-37(d) could subject the dealer to enforcement actions by the appropriate regulatory authorities.

2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act, which authorizes that the MSRB's rules shall:

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.

The MSRB believes that the proposed rule change is consistent with the Exchange Act because it will help inhibit practices that create the appearance of attempting to influence the awarding of municipal securities business through an indirect violation of Rule G-37. The MSRB also believes that the Q&A guidance will facilitate dealer compliance with Rule G-27, on supervision, and Rule G-37(d)'s prohibitions on indirect rule violations.

B. Self-Regulatory Organization's Statement on Burden on Competition

The MSRB does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act since it would apply equally to all dealers.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

On February 15, 2005 the MSRB published for industry comment draft amendments to Rule G-37(c), concerning solicitation and coordination of payments to political parties, and draft Q&A guidance on supervisory procedures related to Rule G-37(d), on indirect violations (the "Notice").[5] The MSRB received seven comments on the Notice.[6]

Of the seven commentators, one commentator, American Municipal, supports the adoption of the amendments to Rule G-37 and the proposed Qs&As because they will

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5 *See* MSRB Notice 2005-11 (February 15, 2005).

6 The Board received comment letters from the following: Sarah A. Miller, General Counsel, ABASA Securities Association ("ABASA") to Carolyn Walsh, Senior Associate General Counsel MSRB, dated April 11, 2005; J. Cooper Petagna, Jr., President, American Municipal Securities, Inc. ("American Municipal") to Ms. Walsh, dated March 10, 2005; Robert E. Foran, Senior Managing Director, Bear Stearns & Co., Inc. ("Bear Stearns") to Ms. Walsh, dated March 31, 2005; Leslie M. Norwood, Vice-President and Assistant General Counsel, Bond Market Association ("BMA") to Ms. Walsh, dated April 1, 2005; Robert J. Stracks, Counsel, Griffin, Kubik, Stephens & Thompson, Inc. ("Griffin, Kubik") to Ms. Walsh, dated March 30, 2005; Marc E. Lackritz, President, Securities Industry Association ("SIA") to Ms. Walsh, dated April 5, 2005; and Terry L. Atkinson, Managing Director, UBS Financial Services Inc. ("UBS") to Ms. Walsh, dated April 1, 2005.

strengthen the effectiveness of the rule in preventing improper political contributions.[7] One commentator, Griffin, Kubik, believes that the existing structure of Rule G-37 is unconstitutional and complains about the existing operation of Rule G-37.[8] Griffin, Kubik also suggests that requiring full and immediate disclosure of dealer contributions by the recipient issuer official would be more effective in policing this arena.

The remaining five commentators express support for the MSRB's efforts to eliminate any vestiges of pay-to-play in the municipal securities industry, whether they are in the form of a direct or indirect contribution to an issuer official. However, ABASA, BMA[9], SIA and UBS assert that the Qs&As are vague thus making it impossible for broker-dealers to know exactly what standard to apply. ABASA, BMA, SIA and UBS request that the MSRB clarify the proposed Qs&As as they relate to contributions to party committees and PACs so that they establish clear standards upon which the industry may rely. BMA, SIA and UBS request that the MSRB expressly state that contributions made to national party committees and certain federal leadership PACs

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7 American Municipal also suggests that consideration be given to having the rule applied to all registered personnel and not just MFPs.

8 This commentator complains that if an associated person of a dealer introduces or solicits municipal securities business for the dealer while at the same time making political contributions to an official of a completely different local political body, the broker-dealer could face a G-37 compliance problem. In fact, assuming this was the first time the associated person solicited municipal securities business for the dealer, the contribution to an issuer official who is not the issuer official solicited would not result in a ban on doing business with the introduced issuer. It would, however, result in the associated person becoming a municipal finance professional of the dealer and being subject to Rule G-37 from the date of the solicitation activity forward.

9 Because the Bear Stearns comment letter simply states that it supports the BMA letter, for the purposes of this discussion Bear Stearns' positions will not be separately identified. Rather, it should be understood that positions attributed to BMA are also supported by Bear Stearns.

(controlled by members of Congress) are permitted. BMA and UBS also request that the MSRB: (1) acknowledge that the proposed Qs&As reflect a new approach to Rule G-37's prohibition on indirect contributions and not just a restatement of the existing standard; (2) modify the prohibition on soliciting contributions to state or local parties so that broker-dealers and MFPs would be permitted to solicit contributions to the same extent they are able to make a contribution to them; and (3) clarify what is meant by "affiliated PAC" for purposes of erecting an informational barrier.[10] ABASA also states that the MSRB's suggested information barrier concerning past and current municipal securities business is unrealistic because much of the information is public. These specific comments are discussed in detail below.

The Draft Amendments to Rule G-37(c)(ii): The Prohibition on Soliciting Contributions to State and Local Party Committees Should be Symmetrical to the Contributions Ban.

Comments Received. BMA and UBS assert that the Rule G-37(c) amendment should be symmetrical to the contributions ban because they do not believe it makes sense to impose a greater, absolute prohibition on soliciting contributions than on making contributions. BMA recommends that dealers and MFPs be permitted to solicit contributions to the same extent they are allowed to make contributions.

MSRB Response. The proposed rule amendment is more limited than what the comment letters portray. The comment letters state that the amendment would

[10] Griffin, Kubik also seeks this clarification.

completely prohibit MFPs from soliciting contributions to any state and local party committees when, in fact, it only prohibits solicitations by the dealer or certain MFPs for contributions to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business. Thus, the proposed amendment is narrowly tailored to regulate only a dealer's or certain MFP's solicitation of other persons' payments to political parties when there can be a perception that MFPs and dealers are soliciting others to make payments to parties or PACs as an end-run around the rule and the rule's disclosure requirements.

Current Rule G-37(c) operates as an absolute prohibition on soliciting contributions for an official of an issuer with which the dealer is engaging or seeking to engage in municipal securities business and is not symmetrical with Rule G-37(b) because there is no *de minimus* exception in Rule G-37(c). Moreover, because dealers' and MFPs' payments to political parties do not trigger the automatic ban on business (unless there is an indirect violation) there is no mechanism to correlate the party payment disclosure scheme in Rule G-37 with the proposed prohibition on the solicitation and coordination of payments to political parties of states or localities where the dealer is engaging or seeking to engage in municipal securities business.

The MSRB determined that allowing dealers or certain MFPs to solicit other persons to make political party or PAC payments in states and localities where they are engaging or seeking to engage in municipal securities business creates at least the appearance of attempting to influence the awarding of municipal securities business through such payments. Moreover, without the proposed prohibition, it would be very difficult for enforcement agencies to detect such potential indirect violations because the

parties solicited do not have to disclose the payments. Additionally, the arguably stricter prohibition can be justified because a violation of Rule G-37(c) does not result in an automatic ban on business.

Vagueness of the Proposed Q&A Guidance Concerning Rule G-27, on Supervision, and Rule G-37(d), on Indirect Violations.

Comments Received. ABASA, BMA, SIA, and UBS request that the Qs&As be clarified because they do not present a clear objective standard as to when party and PAC contributions should be treated as indirect contributions to issuer candidates. BMA, SIA and UBS also complain that the Qs&As represent an expansion of Rule G-37. BMA suggests that if the MSRB's intent is to absolutely eliminate state and local party committee and PAC contributions, it should come out with a clear prohibition.

MSRB Response. The MSRB's intent was *not* to eliminate all state and local party committee and PAC contributions or to specify which ones would not be indirect contributions to issuer officials. The MSRB recognizes that some payments to political parties are made for reasons that have no connection with influencing the awarding of municipal securities business. The MSRB's decision to issue the proposed Q&A guidance was prompted by concern that dealers are not implementing adequate supervisory procedures reasonably designed to prevent indirect rule violations. The MSRB also voiced its concern about the emergence of recent media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from

contributing directly to an issuer official's campaign, they should contribute to the affiliated party's "housekeeping" account.

By voicing a concern that dealers who make such payments to parties or PACs *may* be doing so in an effort to avoid the political contribution limitations embodied in Rule G-37, the MSRB was not expanding the reach of Rule G-37. The MSRB was, however, alerting dealers to modern day political realities and practices that may prove—with hindsight—to be problematic. The MSRB was also suggesting, though not requiring, general supervisory procedures designed to help ensure that the party or PAC payments do not result in a violation of Rule G-37(d). Dealers are required to implement adequate supervisory procedures, but the MSRB's suggestions about general approaches to conducting adequate due diligence are not meant to be either required procedures or a safe harbor. Ideally, an adequate supervisory procedure will prevent a Rule G-37(d) violation, but the existence of adequate supervisory procedures may only protect the firm from a resulting Rule G-27 violation should a problem later occur. A payment permitted by the dealer's supervisory procedures may still result in a violation of Rule G-37(d) if it is later proven that the MFP in question contributed with the intent to circumvent the rule. Such instance, of course, could put the dealer in a good position to seek a waiver of the resulting ban on business from the NASD.

Moreover, the proposed Qs&As do not broaden the sphere of activity that is prohibited by Rule G-37. A violation of Rule G-37(d) still will only occur when the payment is made to other entities "as a means to circumvent the rule." Rule G-37(d), which prohibits anyone from "directly or indirectly, through or by any other person or

means" doing what sections (b) and (c) prohibit has previously been challenged on the grounds that it is unconstitutionally vague. The United States Court of Appeals in *Blount v. SEC*[11] rejected this challenge 10 years ago. In *Blount,* the Court stated,

> Although the language of section (d) itself is very broad, the SEC has interpreted it as requiring a showing of culpable intent, that is, a demonstration that the conduct was undertaken "as a means to circumvent" the requirements of (b) and (c). . . . The SEC states its "means to circumvent" qualification in general terms. The qualification appears, therefore, to apply not only to such items as contributions made by the broker's or dealer's family members or employees, but also gifts by a broker to a state or national party committee, made with the knowledge that some part of the gift is likely to be transmitted to an official excluded by Rule G-37. In short, according to the SEC, the rule restricts such gifts and contributions only when they are intended as end-runs around the direct contribution limitations.[12]

The Standards in the "Reasons Test" and "Activity Test" Need to be Clarified.

Comments Received. ABASA, BMA, SIA and UBS assert that the proposed Q&A guidance should be clarified with bright-line tests to identify the parties or PACs to which dealers and MFPs can make payments without violating Rule G-37(d), on indirect violations. In particular, the commentators object to the guidance that suggests that the dealer identify the reason for making the payment to the party or PAC (the "reasons test") without defining the motivation(s) that should result in a contribution being classified as an indirect contribution to an issuer official. BMA suggests that the reasons test be clarified to only cover contributions to party committees and PACs that are controlled by, or where the contribution is solicited by, an issuer official.

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11 *Blount v. SEC,* 61 F.3d 938, (D.C. Cir. 1995), *rehearing and suggestion for rehearing en banc denied* (1995), *certiorari denied by* 517 U.S. 1119, 116 S.Ct. 1351, 134 L.Ed.2d 520 (1996).

12 *Id* at 948.

The commentators also object to the suggestion that dealers make inquiries to essentially "follow the money" to reasonably ensure that the party or PAC is not supporting one or a limited number of issuer officials (the "activity test") on the grounds that it is unclear. BMA asserts that the language is unclear because it could mean one of two things: (1) if the party or PAC that receives the contribution supports even one issuer official, then an indirect ban is triggered; or (2) the dealer must determine that the party's or PAC's expenditures on issuer officials constitute a large enough portion of its total expenditures such that an indirect ban is triggered. BMA and UBS ask the MSRB to revise its guidance to suggest a test based on objective criteria. UBS suggests that this objective criteria include a "dilution standard" that would need to include at least the following elements: (1) a threshold—50%, 60% or 70% --of a party's or PAC's expenditures used for non-issuer purposes that would be sufficient to overcome a presumption that the committee supported one or a limited number of issuer officials, and (2) a time period over which the party committee or PAC would be required to examine when calculating the threshold percentage.

MSRB Response. As discussed above, the proposed Q&A guidance does not change the existing legal framework concerning the motivation that would result in a contribution being classified as an indirect contribution to an issuer official. An MFP or dealer could be found (after the fact) to have violated Rule G-37(d) if payments to a party or PAC are intended as end-runs around the direct contribution limitations. The MSRB does not believe it is appropriate to attempt to delineate specific reasons that are permissible, and those that are not. What is important is that dealers institute adequate

procedures to identify potential violations. If the dealer's procedures include making an inquiry about the reason for making the payment[13] the dealer must then exercise its judgment as to whether the facts and circumstances surrounding the payment indicate that the reason for making the contribution was to circumvent Rule G-37.

With regard to the "activity test" comments, the MSRB's existing Q&A guidance on this issue already states that dealers that make contributions to organizations such as political parties or PACs (as well as dealers that allow MFPs to make such payments) have a duty to make inquiries of such organizations in order to ascertain how the contributed funds will be used.[14] Following this guidance, dealers should be able to develop adequate written supervisory procedures reasonably designed to ensure that payments to political parties or PACs are not being used to circumvent the requirements of Rule G-37. The MSRB does not believe it is useful to provide "safe harbors" concerning parties or PACs such that a dealer or MFP could make payments to certain parties or PACs without investigating whether the payment is actually being made as a means to circumvent the requirements of Rule G-37. Such "safe harbors" create the potential for loopholes in Rule G-37's regulatory scheme as parties and PACs tailor their solicitations for contributions to MSRB suggested parameters.

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13 To the extent that dealers are concerned that the act of inquiring about persons' reasons for making payments to PACs and political partiers may chill political speech, the procedure could require persons to give negative assurances that the party or PAC payment is not being made as a means to circumvent the requirements of Rule G-37.

14 *See* Rule G-37 Questions and Answers No. III. 5, *reprinted in* MSRB Rule Book. *See also* Rule G-37 Questions and Answers Nos. III.3 and III.4, *reprinted in* MSRB Rule Book.

However, the MSRB has determined to revise the guidance and remove some of the specific due diligence suggestions to focus on reminding dealers that each dealer is required under Rule G-27, on supervision, to evaluate its own circumstances and develop written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance with Rule G-37(d), on indirect violations. After evaluating it's own circumstances, a dealer could determine that adequate supervisory procedures would include some of the commentators' suggested due diligence procedures.

National Party Committees and Federal Leadership PACs Should be Expressly Permitted.

Comments Received. BMA, SIA and UBS request that, while they believe contributions to national party committees and federal leadership PACs appear to be permitted under the due diligence standards established by the proposed Qs&As, the MSRB should expressly state that contributions made to a national party committee or federal leadership PAC are permitted under the proposed Qs&As as long as (1) the contribution was not solicited by an issuer official, and (2) the party committee or leadership PAC is not controlled by an issuer official.

MSRB Response. Essentially, the commentators are asking the MSRB to create a safe harbor for certain national party committees and federal leadership PACs. The creation of such a safe harbor would be a departure from the intended reach of Rule G-

37(d). As noted above, the Court of Appeals in *Blount* expressly recognized that Rule G-37 (d) was originally intended to prevent payments to both *national* and state parties used as a "means to circumvent" Rule G-37. Moreover, although BMA, SIA and UBS essentially assert that when a contribution is not solicited by an issuer official and the party leadership PAC is not controlled by an issuer official the national party committees and federal leadership PACs can not be used as a means to circumvent Rule G-37, such a position is inconsistent with public perception.[15] Additionally, the Supreme Court's recent decision in *McConnell v. Federal Election Commission,*[16] emphasized the potential for payments to a political party to have undue influence on the actions of the elected officeholders belonging to the same party. *McConnell* upheld new federal statutory restrictions on soft money donations that were neither solicited by candidates nor used by the party to aid specific candidates. Given public perception and the Supreme Court's pronouncements, the MSRB believes it is reasonable to require dealers to be responsible for having adequate supervisory procedures that obligate the dealer to exercise its judgment concerning whether contributions to any party or PAC are being made as a means to circumvent the provisions of Rule G-37.

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15 *See e.g.*, Spina, Naples favors one underwriter GOP backer gets 80% of county bond business, even at $500,000 higher cost, *The Buffalo News, April 6, 2005* at p. A1 (suggesting that an MFP's contributions to a PAC run by House Majority Leader Tom Delay were transferred to the congressional campaign of a sitting issuer official that awarded 14 of 24 bond deals to firms that the MFP was associated with).

16 *McConnell v. Federal Election Commission*, 540 U.S. 93, 124 S.Ct. 619 (Dec. 10, 2003).

The Existence of a "Safe-Harbor" For Payments to "Housekeeping" Or "Conference" Accounts

Comments Received. The BMA and UBS assert that the MSRB's statements in the Notice are a departure from prior statements because previously the MSRB recognized a "safe-harbor" that expressly permitted contributions to "conference accounts" of state and local party committees. ABASA also states that the MSRB has with the draft Qs&As, in effect, outlawed contributions to housekeeping and similar accounts.

MSRB Response. The MSRB's statements in the Notice about the status of "housekeeping" or "conference" type accounts were made to correct a misconception about these types of accounts. Although the MSRB never recognized such accounts as a safe-harbor, the MSRB learned that some dealers might have believed that payments to a "housekeeping" type account could not result in an indirect violation of Rule G-37. The SEC's approval order of certain early amendments to Rule G-37 demonstrates that the MSRB never intended for dealers to treat payments to administrative accounts as a safe harbor.[17]

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[17] *See* Securities and Exchange Act Release No. 35446 (SEC Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Rule G-37 on Political Contributions and Prohibitions on Municipal Securities Business, and Rule G-8, on Recordkeeping) (March 6, 1995) ("1995 SEC Approval Order").

In 1995, the MSRB filed and the SEC approved amendments to Rule G-37's disclosure requirements to require dealers to record and report all *payments* to parties by dealers, PACs, MFPs and executive officers regardless of whether those payments constitute *contributions*. In the 1995 SEC Approval Order, the SEC reiterated that the party payment disclosure requirements are intended to help ensure that dealers do not circumvent the prohibition on business in the rule by indirect contributions to issuer officials through payments to political parties. The SEC explained that the need for the language amendment was motivated by attempts by dealers and/or political parties to assert that contributions to administrative type accounts did not fall within the rule's regulatory ambit. In the 1995 SEC Approval Order, the SEC states:

> Certain dealers and other industry participants have notified the MSRB that certain political parties currently are engaging in fundraising practices which, according to these political parties, do not invoke the application of rule G-37. For example, some of these entities currently are urging dealers to make payments to political parties earmarked for expenses other than political contributions (such as administrative expenses or voter registration drives). Since these payments would not constitute "contributions" under the rule, the recordkeeping and reporting provisions would not apply. The MSRB is concerned, based upon this information, that the same pay-to-play pressures that motivated the MSRB to adopt rule G-37 may be emerging in connection with the fundraising practices of certain political parties described above.[18]

In addition, in August 2003, when the MSRB published a notice on indirect rule violations of Rule G-37, the MSRB referenced the 1995 SEC Approval Order and specifically stated that, "The party payment disclosure requirements were intended to assist in severing any connection between payments to political parties (*even if*

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[18] *Id.* at p.7.

earmarked for expenses other than political contributions) and the awarding of municipal securities business."[19]

The Term Affiliated PAC should be Clarified.

The BMA states that, while the proposed Qs&As suggest that a broker-dealer establish an informational barrier between it and its affiliated PAC, the MSRB does not clarify what it means by the term "affiliated PAC." The BMA also states that the MSRB should clarify "affiliated PAC" to mean a PAC that is controlled by a wholly owned affiliate of the broker-dealer.

MSRB Response. The MSRB has accepted the suggestion that the term "affiliated PAC" should be defined in the guidance and has revised the guidance to provide that for the purposes of this guidance the term "affiliated PAC" means a PAC controlled by an affiliated entity of a dealer. An "affiliated entity" is an entity that controls, is controlled by or is under common control with the dealer. This use of the term "affiliated" is consistent with the use of the term in the MSRB's proposed amendments to Rule G-38(b)(ii), on consultants.[20]

Recommendations Concerning Information Barriers.

Comments Received. ABASA states that the MSRB's suggestion that dealers establish an information barrier prohibiting sharing information about prior negotiated municipal securities business as well as current and planned solicitations between the

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19 MSRB Notice 2003-32 (August 6, 2003) at pp. 1-2 (emphasis added).

20 *See* File No. SR-MSRB-2005-04.

dealer, its MFPs and any affiliated PAC is unrealistic because much of the information is public.

MSRB Response. The MSRB has revised the language relating to the municipal securities business information barrier to suggest that dealers prohibit the dealer and its MFPs from directly providing or coordinating information about prior negotiated municipal securities business as well as current and planned solicitations to any affiliated PAC.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml) or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2005-12 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-MSRB-2005-12. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available

publicly. All submissions should refer to File Number SR-MSRB-2005-12 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[21]

Jonathan G. Katz
Secretary

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[21] 17 CFR 200.30-3(a)(12).

EXHIBT 2

MSRB NOTICE 2005-11 (FEBRUARY 15, 2005)

RULE G-37: REQUEST FOR COMMENTS ON DRAFT AMENDMENTS TO RULE G-37(c), RELATING TO PROHIBITING SOLICITATION AND COORDINATION OF PAYMENTS TO POLITICAL PARTIES, AND DRAFT QUESTION AND ANSWER GUIDANCE CONCERNING INDIRECT RULE VIOLATIONS

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BACKGROUND

In August 2003, the Municipal Securities Rulemaking Board ("MSRB" or "Board") published a notice concerning indirect rule violations of Rule G-37, on political contributions, and Rule G-38, on consultants (the "2003 Notice").[1] In the 2003 Notice, the MSRB noted that it was concerned with increasing signs that individuals and brokers, dealers, and municipal securities dealers (collectively "dealers") may be seeking ways around Rule G-37 through payments to political parties or non-dealer controlled political action committees ("PACs") that benefit issuer officials; significant political contributions by dealer affiliates (*e.g.,* bank holding companies and affiliated derivative counterparty subsidiaries) to both issuer officials and political parties; and contributions by associated persons of the dealer who are not MFPs to issuer officials and political parties. The Board also reminded dealers that, while Rule G-37 was adopted to deal specifically with contributions made to officials of issuers by dealers and municipal finance professionals ("MFPs"), or PACs controlled by the dealer or MFPs, the rule also prohibits MFPs and dealers from using conduits—be they parties, PACs, affiliates, consultants, lawyers, or spouses—to contribute indirectly to an issuer official if such MFP or dealer can not give directly to the issuer without triggering the ban on business.[2]

Several years prior to the publication of the 2003 Notice, the Board had provided Question and Answer ("Q&A") guidance with regard to supervisory procedures[3] that dealers should have in place in connection with making payments to a non-dealer associated PAC or a political party to avoid indirect rule violations. This guidance related to the need for dealers to make inquiries to a non-dealer associated PAC or a political party concerning how the funds will be used before making any payments to ensure that the funds will not be used to support one or a limited number of issuer officials.[4] Both the 1996 Q&A guidance and the 2003 Notice were intended to alert dealers and MFPs to the realities of political fundraising and guide them toward developing procedures that would lead to compliance with both the letter and the spirit of the Rule. The MSRB continues to be concerned, however, that dealer, MFP, and affiliated persons' payments to political parties, including "housekeeping", "conference" or "overhead" type accounts, and PACs give rise to at least the appearance that dealers may be circumventing the intent of Rule G-37. In this regard, the MSRB is especially troubled by the emergence of recent media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to the affiliated party's "housekeeping" account. The MSRB is concerned that dealers or MFPs who make such payments may be doing so in an effort to avoid the political contribution limitations embodied in Rule G-37.

In addition, recently NASD staff advised the MSRB of its concern about the adequacy of dealers' supervisory procedures to ensure compliance with Rule G-37(d), on indirect violations. NASD staff informed the MSRB that they are particularly concerned

about payroll deduction plans made available to MFP's that enable automated or periodic direct payroll deductions from an MFP's pay or compensation into an affiliated entity's PAC, particularly when such payroll contributions are made to an affiliated PAC without appropriate information barriers, or when the contributions to the affiliated PAC constitute an amount sufficient to control the PAC on a *defacto* basis. NASD staff also indicated that clearer guidance about potential indirect violations and adequate supervisory procedures by the MSRB would assist preventive compliance initiatives by dealers and would result in more effective enforcement.

Thus, the MSRB has determined to publish for comment draft amendments to Rule G-37(c), concerning solicitation and coordination of payments to political parties, and draft Q&A guidance on supervisory procedures related to Rule G-37(d).

DRAFT RULE G-37(c) AMENDMENT

Rule G-37(c) prohibits the dealer and its MFPs from soliciting any person or PAC to make or coordinate contributions to an official of an issuer with which the dealer is engaging or is seeking to engage in municipal securities business. The draft amendments (new section (c)(ii)) would also prohibit the dealer and certain MFPs[5] from soliciting any person or PAC to make or coordinate a payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business.[6]

The draft rule amendments also would specifically define any "person,"[7] in both current Rule G-37 (c) and in the draft amendments, to include any affiliated entity of the dealer. This clarification is intended to alert dealers and MFPs that influencing the disbursement decisions of affiliated entities or PACs may constitute a direct violation of Rule G-37(c), as amended, if the dealer or MFP solicits the affiliated entity or PAC to make or coordinate contributions to an official of an issuer or a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities business. Accordingly, in order to ensure compliance with Rule G-37(c), dealers should consider the adequacy of their information barriers with affiliated entities, or PACs controlled by affiliated entities, to ensure that the affiliated entities' contributions, payments, or PAC disbursement decisions are neither influenced by the dealer or its MFPs, nor communicated to its MFPs.

DRAFT QUESTIONS AND ANSWERS

The draft Q&A guidance based on Rule G-27(c), on supervision, states that each dealer must adopt, maintain and enforce written supervisory procedures to ensure that neither the dealer nor its MFPs are using payments to political parties or PACs to contribute indirectly to an official of an issuer in contravention of Rule G-37(d). Dealers must have written supervisory procedures to ensure that the dealer performs adequate due diligence prior to allowing political party payments by the dealer or its MFPs to ensure that the political party or PAC is not using the money for the support of one or a limited number of issuer candidates.[8] The draft Q&A guidance also advises dealers to inquire about the dealer's or MFP's intent in making the political party or PAC payment to determine if the payment is made for the purpose of benefiting an issuer official. The MSRB believes that supervisory procedures that include the obligation to do due diligence about the reason for the payment will identify and halt practices that are designed to circumvent Rule G-37. The draft Q&A guidance also explicitly states that contributing to "housekeeping", "conference" or "overhead" type political party accounts is not a safe harbor and does not alleviate the dealer's supervisory obligation to conduct this due diligence.

The notice, draft rule language amendments, and accompanying Qs&As seek to provide dealers with more guidance as they develop procedures to ensure compliance with both the language and the spirit of Rule G-37. The Qs&As emphasize the necessity for adequate supervisory procedures to ensure compliance with Rule G-37(d) not only

with respect to payments to political parties, but also with respect to contributions to and disbursements by dealer-affiliated (but not controlled) PACs. The Board reminds dealers that a failure to implement satisfactory written procedures to ensure compliance with Rule G-37(d) could subject the dealer to enforcement actions by the appropriate regulatory authorities.

REQUEST FOR COMMENT

The MSRB notes that its rules currently require dealers to adopt adequate supervisory procedures to ensure compliance with Rule G-37(d). Moreover, the MSRB has long-standing Q&A guidance relating to dealers' obligation to conduct due diligence prior to allowing political party payments by the dealer or its MFPs to ensure that the political party or PAC is not using the money for the support of one or a limited number of issuer candidates. However, the draft Qs&As are being published with a 45-day comment period because the MSRB is adding suggestions for best practices for supervisory procedures, as well as providing clarity about the status of "housekeeping", "conference" or "overhead" type political party accounts, and requests comment on these suggestions. The MSRB also requests comment on the draft amendments to Rule G-37(c), on solicitation and coordination of political party payments.

Comments from all interested parties are welcome. Comments should be submitted no later than April 1, 2005 and may be directed to Carolyn Walsh, Senior Associate General Counsel. Written comments will be available for public inspection.

February 15, 2005

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TEXT OF DRAFT AMENDMENT*

Rule G-37(c).

(c) (i) No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any contribution, or shall coordinate any contributions, to an official of an issuer with which the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

(ii) No broker, dealer or municipal securities dealer or any individual designated as a municipal finance professional of the broker, dealer or municipal securities dealer pursuant to subparagraphs (A), (B), or (C) of paragraph (g)(iv) of this rule shall solicit any person, including but not limited to any affiliated entity of the broker, dealer or municipal securities dealer, or political action committee to make any payment, or shall coordinate any payments, to a political party of a state or locality where the broker, dealer or municipal securities dealer is engaging or is seeking to engage in municipal securities business.

* Strikethrough indicates deletions, underlining denotes additions.

TEXT OF DRAFT QUESTIONS AND ANSWERS

Rule G-37 Questions-and-Answers

1.

Q: Is a broker, dealer or municipal securities dealer ("dealer") required to have written supervisory procedures in place to ensure compliance with Rule G-37(d), on indirect

contributions and solicitations, with regard to payments to political parties and PACs by a dealer or its municipal finance professionals ("MFPs")?

A: Yes. The relevant portion of the MSRB's supervision rule, Rule G-27(c), provides that, "Each dealer shall adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance [with MSRB rules]."

Rule G-37(d) provides that: "No broker, dealer or municipal securities dealer or any municipal finance professional of the broker, dealer or municipal securities dealer shall, directly or indirectly, through or by any other person or means, do any act which would result in a violation of sections (b) or (c) of this rule." While Rule G-37 was adopted to deal specifically with contributions made to officials of issuers by dealers and municipal finance professionals, and political action committees ("PACs") controlled by dealers or MFPs, this section of the rule also prohibits MFPs and dealers from using conduits—be they parties, PACs, affiliates, consultants, lawyers or spouses—to contribute indirectly to an issuer official if such MFP or dealer can not give directly to the issuer without triggering the ban on business.

Therefore, each dealer must adopt, maintain and enforce written supervisory procedures to ensure that neither the dealer nor its MFPs are using payments to political parties and non-dealer controlled PACs to contribute indirectly to an official of an issuer.[9] For example, a dealer's written supervisory procedures might provide that, if the dealer or any of its MFPs want to make payments to political parties or PACs, the dealer must perform adequate due diligence **prior** to allowing political party or PAC payments by the dealer or its MFPs to ensure that the political party or political organization is not using the money for the support of one or a limited number of issuer candidates (*i.e.*, that the party or PAC itself does not raise money to support one or a limited number of issuer officials, and the party does not transfer money to other state or local parties that support one or a limited number of issuer officials).[10] Such due diligence might include inquiring about and documenting the intent or motive in making the payment, whether the party payment or PAC contribution was solicited by anyone, and if so, the identification of the person soliciting the party payment and a record of written solicitations. This information will assist the dealer in determining whether the facts and circumstances surrounding the payment support the reason given for making the payment.

Finally, to ensure compliance with Rule G-37(d) in connection with contributions by dealers or MFPs to non-controlled (but affiliated) PACs, the dealer might adopt information barriers between any affiliated PACs and the dealer or its MFPs. Examples of such information barrier provisions might include:

- a prohibition on the dealer or MFPs from recommending, nominating, appointing or approving the management of affiliated PACs;
- a prohibition on sharing the affiliated PAC's meeting agenda, meeting schedule, or meeting minutes;
- a prohibition on identification of prior affiliated PAC contributions, planned PAC contributions or anticipated PAC contributions;
- a prohibition on information sharing about prior negotiated municipal securities business, solicited municipal securities business, and planned solicitations of municipal securities business; and
- other such information barriers as the firm deems appropriate to effectively monitor conflicting interests and prevent abuses.

2.

Q: Is a dealer required to have written supervisory procedures in place to ensure compliance with Rule G-37(d) if the dealer only allows the dealer or its municipal finance professionals ("MFPs") to make political party payments to "housekeeping", "conference" or "overhead" type accounts of a political party?

A: Yes. There is no safe harbor under Rule G-37 for payments to "housekeeping", "conference" or "overhead" type political party accounts. The dealer must have adequate supervisory procedures in place to prevent a violation of Rule G-37(d), on indirect political contributions, even when the payments are being made to a "housekeeping", "conference" or "overhead" type account. While the political party itself may prohibit direct contributions to issuer official candidates from "housekeeping" accounts, payments to these accounts might be used for political party events that are focused to benefit a specific candidate or a small number of candidates. Additionally, because money is fungible, a payment made to a fund earmarked for non-issuer official elections might "free up" other money to support the candidacy of specific issuer officials.

The need for dealers to adopt adequate written supervisory procedures to prevent indirect violations via "housekeeping", "conference" or "overhead" type political party accounts is especially important in light of media and other reports that issuer agents have informed dealers and MFPs that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to an affiliated party's "housekeeping" account. In addition, NASD staff has informed the MSRB that some firms make contributions to "housekeeping" accounts or PAC's with explicit instructions accompanying the contribution that the contribution is not to be used for the benefit of one or a limited number of issuer officials. In light of the above, the MSRB does not consider such "preemptive" disclosures or instructions sufficient to meet the dealer's obligation to perform due diligence to ensure that the political party or PAC is not using the money in support of one or a limited number of candidates. The dealer should conduct due diligence to identify the reason for making the payment and should receive affirmative assurance from the party or PAC that the party or PAC itself does not raise money to support one or a limited number of issuer officials, and the party or PAC does not transfer money to other state or local parties or PACs that support one or a limited number of issuer officials.

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[1] MSRB Notice Concerning Indirect Rule Violations: Rules G-37 and G-38(August 6, 2003), reprinted in *MSRB Rule Book*.

[2] *See* MSRB Rule G-37(d).

[3] Rule G-27, on supervision, in section (c) provides that, "Each dealer shall adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance [with MSRB rules]."

[4] *See Questions and Answers Notice: Rule G-37 Nos. III.4 and III.5* (August 6, 1996) ("1996 Q&A"), reprinted in *MSRB Rule Book*.

[5] The draft amendment limits MFPs who would be prohibited from soliciting or coordinating political party payments to those persons who are directly involved in the dealer's municipal securities business. The draft language provides that only MFPs who are primarily engaged in municipal representative activities, solicitors of municipal securities business, or direct supervisors of MFPs that are "solicitors" or "primarily engaged" are prohibited from soliciting political party payments. The Board limited those MFPs covered by the draft amendments to those directly involved in the municipal securities business of the dealer; recognizing that other MFPs more distant from the day-to-day operations of the dealer's municipal securities business may have other reasons to

solicit or coordinate payments to political parties (*i.e.*, reasons related to other business activities of the dealer).

[6] The MSRB notes that, depending upon the facts and circumstances, an MFP's solicitation of a contribution to an issuer with which the dealer is engaging or is seeking to engage in municipal securities business or the solicitation of a political party payment to a political party of a state or locality where the dealer is engaging or is seeking to engage in municipal securities, may also constitute a violation of Rule G-37(d), on indirect violations.

[7] "Person" is defined in the Securities Exchange Act of 1934 (the "Act"), § 3(9) to mean " a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Unless the context otherwise specifically require, the terms used in MSRB Rules have the meanings set forth in the Act. *See* MSRB Rule D-1.

[8] *See Questions and Answers Notice: Rule G-37 Nos. III.4 and III.5* (August 6, 1996), reprinted in *MSRB Rule Book*.

[9] In addition, pursuant to MSRB Rule G-8(a)(xx), on Records Concerning Compliance with Rule G-27, each dealer must maintain and keep current the records required under Rules G-27(c) and G-27 (d).

[10] *See Questions and Answers Notice: Rule G-37 Nos. III.4 and III.5* (August 6, 1996), reprinted in *MSRB Rule Book*.

Alphabetical List of Comment Letters on MSRB Notice 2005-11 (February 15, 2005)

1. ABASA Securities Association: Letter to Carolyn Walsh, MSRB, from Sarah A. Miller, General Counsel (April 11, 2005)
2. American Municipal Securities, Inc.: Letter to Carolyn Walsh, MSRB, from J. Cooper Petagna, Jr., President (March 10, 2005)
3. Bear Stearns & Co., Inc.: Letter to Carolyn Walsh, MSRB, from Robert E. Foran, Senior Managing Director (March 31, 2005)
4. Bond Market Association: Letter to Carolyn Walsh, MSRB, from Leslie M. Norwood, Vice President and Assistant General Counsel (April 1, 2005)
5. Griffin, Kubik, Stephens & Thompson, Inc.: Letter to Carolyn Walsh, MSRB, from David M. Thompson, President and Robert J. Stracks, Counsel (March 30, 2005)
6. Securities Industry Association: Letter to Carolyn Walsh, MSRB, from Marc E. Lackritz, President (April 5, 2005)
7. UBS Financial Services Inc.: Letter to Carolyn Walsh, MSRB, from Terry L. Atkinson, Managing Director (April 1, 2005)

ABA SECURITIES ASSOCIATION

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April 11, 2005

Carolyn Walsh
Senior Associate General Counsel
Municipal Securities Rulemaking
Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

Re: Draft Amendments to Rule G-37 and Draft Q&As
MSRB Notice 2005-11, February 15, 2005

Dear Ms. Walsh:

The ABA Securities Association[1] ("ABASA") is responding to the request of the Municipal Securities Rulemaking Board ("MSRB") for comments on its draft amendments to Rule G-37 and draft Questions and Answers ("Q&As") concerning indirect violations of Rule G-37.

The MSRB has proposed the draft amendments as a result of its continuing concerns about contributions to issuer officials by municipal securities dealers and municipal finance professionals ("MFPs") through conduits—*i.e.*, political parties, PACs, affiliates, consultants, lawyers, or spouses. In addition, the MSRB is concerned that prior guidance requiring dealers to develop procedures to ensure that the funds will not be used to support one or a limited number of issuer officials is insufficient.

[1] The ABA Securities Association (ABASA) is a separately chartered trade association and non-profit affiliate of the American Bankers Association whose mission is to represent the interests of banks underwriting and dealing in securities, proprietary mutual funds and derivatives before Congress, federal and state governments, and the courts. The views in this letter are also endorsed by the ABA. ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership -- which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest banking trade association in the country.

ABASA Position

ABASA fully supports the elimination of "pay-to-play" in awarding negotiated municipal securities business, whether directly or indirectly. The comments in this letter refer only to affiliated PACs to which MFPs are permitted to contribute. It does not address affiliated PACs that (1) do not accept contributions from the dealer or its MFPs and (2) do not coordinate their activities in any way with the dealer or its MFPs. Indeed, we understand that such PACs are entirely outside the scope of Rule G-37.

As discussed more fully below, ABASA seeks clarification of some of the terms in Q&A #1.

Background

From the perspective of municipal securities dealers affiliated with banking organizations, the proposal would prohibit dealers and their municipal finance professionals ("MFPs") from requesting that their affiliated political action committees (PACs) make or coordinate any contributions:

- Directly to issuer officials with which the dealer is engaged or is seeking to engage in municipal securities business; or
- To a political party of a state or locality where the dealer is engaging in or seeking to engage in municipal securities business.

In addition to the proposed prohibitions in the rule itself, the MSRB has proposed draft Q&As that encourage dealers to establish information barriers between the dealer, its MFPs and any affiliated PAC including:

- Prohibiting the dealer or its MFPs from recommending, nominating, appointing or approving the management of affiliated PACs;
- Prohibiting sharing with the dealer or its MFPs of the affiliated PAC's meeting agenda, schedule or minutes;
- Prohibiting identification of prior, planned or anticipated affiliated PAC contributions; and
- Prohibiting information about prior negotiated municipal securities business as well as current and planned solicitations.

The Q&As also suggest that the dealer and its MFPs ensure, prior to making any contributions, that the affiliated PAC does not limit its contributions to one or a limited number of issuer candidates directly or through contributions for other state or local parties.

Moreover, dealers would also be encouraged to seek and document the reasons why their MFPs make contributions to an affiliated PAC.

Discussion

1. Q&A #1

Information regarding municipal business and PAC contributions. In the case of the suggested information barrier concerning past and current municipal securities business, ABASA believes that the MSRB's suggestion is unrealistic. While it certainly would be possible to prohibit the dealer and its MFPs from directly providing such information to the PAC, the information itself is public. News reports of past, current and future deals routinely run in industry publications such as the *Bond Buyer* as well as in local newspapers, and information about past business is publicly disclosed in Rule G-37 Reports. Moreover, dealers should be able to issue press releases, *etc.*, when they generate business. Publicizing this type of news should not be restricted simply because PAC members may learn about it.

With respect to the suggested prohibition on making PAC contributions public, ABASA agrees that PACs should not directly provide information on planned or anticipated contributions to MFPs.

Prior assurance and reason suggestions. Although Q&A #1 suggests that municipal securities dealers merely consider whether to implement the "prior assurance" and "reason" suggestions, ABASA believes that these suggestions are too vague for banks to rely on them except in the most "black and white" cases, *i.e.*, where the PAC doesn't contribute to any issuer officials.

The MSRB has provided no parameters for the prior assurance requirement if a PAC contributes to more than one issuer candidate. For example, are contributions to three issuer candidates permissible—10 issuer candidates—50 issuer candidates? What if the distributions are made across a broad number of candidates, but the bulk of the money goes to a single issuer candidate? Will PACs then have to calculate the percentage of total contributions each single contribution represents? ABASA believes that the MSRB should provide a range of examples so that dealers are not significantly at risk of being second guessed by examiners from the National Association of Securities Dealers.

With respect to the suggestion that dealers ascertain the reasons why MFPs make contributions, ABASA believes that requiring each individual to provide a reason for making a contribution to his/her company PAC would be burdensome for PACs to administer. More importantly, we believe that such a requirement would definitely chill contributions. This is because most employees want to help their companies prosper and feel it is their obligation to help their companies to help by contributing, ABASA believes, however, that no matter what reason a bank gives for the requirement, employees will almost certainly believe that the information is for company purposes or to see who is "loyal."

2. Q&A #2

With respect to Q&A #2, it appears that the MSRB has, in effect, outlawed contributions to the housekeeping and similar accounts of state and local political parties. Specifically, the statement in the Q&A that because money is fungible, contributions to housekeeping accounts could free up other money that could in turn, be used to support one or a limited number of issuer candidates, seems clearly designed to put such contributions in the highest-risk category. Despite staff assurances that dealers would not have to track and document how their contributions were actually spent, there would seem to be no other way for a dealer to make sure it's affiliated PAC was in compliance with rule G-37.

3. Impact on Bank-Affiliated Dealers

ABASA believes the amendments and proposed Q&As reflect a mis-understanding of the way bank PACs operate. Typically, a bank solicits contributions for its PACs during a single, limited event each year, typically two-three weeks in duration. The solicitations are not related to the political cycle; that is, contributions may be solicited six months or more prior to any contributions being made. While some banks solicit contributions only from higher-level employees, other organizations may solicit many thousands of employees, the vast majority of whom have nothing at all to do with public finance. Employees are offered the opportunity of giving through a single, one-time contribution, or through payroll deductions. Employees who choose to make contributions—in amounts as little as $50 to 100—generally do so in order to help their company be more successful, not because they are trying to influence business with a particular issuer.

With respect to payroll deductions, ABASA believes that the very fact that such arrangements generally involve monthly or semi-monthly deductions mitigates against any perception that such contributions are "earmarked" for or intended to influence a particular issuer.

As the MSRB is well aware, bank PACs contribute to numerous candidates for public office, including candidates that are issuer officials. When bank PACs contribute to such officials, these contributions are based on their overall holding company-wide financial services relationships with issuers as well as candidates' positions on legislation important to the banking organization.

Current environment. As a result of enforcement actions by the Securities and Exchange Commission ("SEC"), banking organizations have largely severed ties between their public finance operations and their PACs. That is, the information barriers suggested by the MSRB in its draft Q&A #1 generally are already in place, (subject to our comments on the public nature of municipal business).

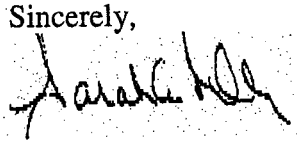
Accordingly, many banks simply prohibit MFPs from making *any* contributions to state or local PACs. Others permit MFPs to contribute *only* to federal PACs that make contributions only to candidates for federal office who are not currently issuer officials. Finally, other bank PACs may not have the wherewithal to create a number of separate PACs. In all of these instances in which MFPs are permitted to contribute to bank-affiliated PACs, ABASA recognizes that in accordance with Q&A #1, the dealer has the discretion to decide the extent to which it will implement the prior assurance and reason suggestions.

Conclusion

In conclusion, ABASA recognizes that where MFPs are permitted to contribute to affiliated bank PACs, dealers have discretion about the extent to which they implement the suggested prior assurance and reason requirements. However, we urge the MSRB to provide examples to clarify the parameters of the information barriers and prior assurance and reason suggestions.

ABASA would be pleased to discuss these issues further with MSRB staff. If there are questions or comments, please contact the Cris Naser at 202-663-5332 for more information.

Sincerely,



Sarah A. Miller

AMERICAN MUNICIPAL SECURITIES, INC.

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March 10, 2005

MSRB
1900 Duke Street
Suite 600
Alexandria, VA 22314

Attn: Carolyn Walsh, Senior Associate General Counsel

Re: MSRB Notice 2005-11
Rule G-37

Ladies and Gentlemen:

We have reviewed the proposed amendments to Rule G-37 as described in the referenced notice. We support the adoption of these changes which will strengthen the effectiveness of the rule in preventing improper political contributions.

It is also suggested that consideration be given to having the rule be applied to all registered personnel and not just Municipal Finance Professionals. A political contribution from a non-MFP registered person might be used to circumvent the rule.

The opportunity to comment on the proposed amendments is appreciated.

Yours truly,

J. Cooper Petagna, Jr.
President

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March 31, 2005

Carolyn Walsh, Esq.
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

Re: Draft Amendments to rule G-37 and Draft Question and Answer Guidance Concerning Indirect Rule Violations.

Dear Ms. Walsh:

We participated in the preparation of and support the contents of the letter submitted by The Bond Market Association on or about April 1, 2005.

Very truly yours,

Robert E. Foran
Senior Managing Director

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April 1, 2005

Carolyn Walsh, Esq.
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

RE: Comments to Proposed Amendment and Interpretations of Rule G-37

Dear Ms. Walsh:

The Bond Market Association ("Association") [1] appreciates this opportunity to respond to the notice ("Notice") issued by the Municipal Securities Rulemaking Board ("MSRB") on February 15, 2005, in which the MSRB proposed an amendment to Rule G-37 and certain Questions and Answers ("Q&As") regarding the ability of broker-dealers and municipal finance professionals ("MFPs") to make and solicit contributions to political party committees and PACs.[2] In particular, the proposed amendment absolutely prohibits broker-dealers and MFPs from soliciting contributions to state and local party committees while the proposed Q&As set forth new due diligence standards for making contributions to party committees and PACs. The proposed Q&As also suggest that informational barriers be erected between a broker-dealer and affiliated PACs that give to issuer officials. The Association continues to support the principles underlying MSRB Rule G-37, and the strict enforcement of all MSRB rules. To that end, the Association fully supports the MSRB's efforts to eliminate any vestiges of pay-to-play in the municipal securities industry, whether they be in the form of a direct or indirect contribution to an issuer official.

However, the Q&As are vague, thus making it impossible for broker-dealers to know exactly what standard to apply. We request that the MSRB (1) clarify the proposed Q&As as they relate to contributions to party committees and PACs so that they establish clear standards upon which the industry may rely; (2) acknowledge that the proposed Q&As reflect a new approach to Rule G-37's

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1 The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities and other credit market instruments in the U.S. and globally. Additional information about the Association and its members and activities is located at www.bondmarkets.com.

2 MSRB Notice 2005-11.

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prohibition on indirect contributions and not just a restatement of some existing standard; (3) expressly state that contributions made to national party committees and certain federal leadership PACs (controlled by members of Congress) are permitted, given the lack of a nexus between these federal entities and state and local issuer officials; (4) modify the prohibition on soliciting contributions to a state or local party committee so that broker-dealers and MFPs would be permitted to solicit contributions to the same extent they are able to make a contribution to them; and (5) clarify what is meant by "affiliated PAC" for purposes of erecting an informational barrier.

1. Brief Description of Proposed Amendment and Q&As

Rule G-37 currently prohibits broker-dealers and MFPs from soliciting contributions on behalf of an issuer official. The proposed amendment would extend this prohibition on solicitation to state and local party committees.

As for the proposed Q&As' new due diligence standard for giving to party committees and PACs, different parts of the Q&As appear to set forth different, and sometimes even conflicting, standards. For example, Q&A 1 states that when giving to a party committee or PAC, a broker-dealer must make sure that its "money [is not used] for the support of one or a limited number of issuer candidates." This confirms the MSRB's prior interpretations that broker-dealers need only track how their contributions are used, thus permitting contributions to an account of a party committee that is not used to support candidates (such as a housekeeping or conference account). However, Q&A 2 states that giving to such housekeeping or conference account is not a safe harbor.

Although we cannot be sure from the language of the Q&As, it appears that the MSRB is creating a two-pronged due diligence requirement, under which the broker-dealer must: (1) gather and keep records of the underlying reasons for making a party committee or PAC contribution ("Underlying Reasons Test"); and (2) ensure that the party committee or PAC (as a whole and not just the account to which the contribution is made) does not "raise money to support one or a limited number of issuer officials" ("Activity Test").

To avoid an indirect violation of Rule G-37, the proposed Q&As also suggest that a broker-dealer erect an informational barrier between it (including its MFPs) and its "affiliated PAC," which gives to issuer officials. Under this barrier, the PAC would not be permitted to share information regarding its contributions with the broker-dealer and the broker-dealer would

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not be permitted to share information regarding its municipal securities business with the PAC.

2. The MSRB Should Acknowledge that the Q&As Reflect a Change in the MSRB's Interpretations

The MSRB has informally made public statements that these proposed Q&As are merely a restatement of an existing standard on political party and PAC contributions under Rule G-37 and that these Q&As do not reflect a change in the MSRB's views. The MSRB has also implied that broker-dealers have been somehow indirectly violating Rule G-37 by giving to so-called housekeeping or conference accounts of party committees.

However, these informal statements and implications raised by the MSRB are belied by not only one, but two formal interpretations issued by the MSRB specifically on this subject. In particular, in the two and only existing Q&As on this subject, the MSRB made clear that a broker-dealer's contribution to a party committee or PAC would not result in an indirect violation of Rule G-37 unless the broker-dealer knows that its contribution will go to issuer officials.[3] Moreover, the MSRB expressly established as a safe harbor where a broker-dealer gets assurances from a party committee or PAC that the broker-dealer's contribution will not be used for issuer officials.[4] This safe-harbor was also recognized in the Voluntary Initiative (a pre-cursor to Rule G-37 that was approved by the Securities and Exchange Commission), which expressly permitted contributions to "conference accounts" of state and local party committees.

Thus, far from attempting to skirt the requirements under Rule G-37, broker-dealers have been making an extra effort to qualify under this express safe harbor by giving to a party committee's housekeeping or conference account, which is not used to support any candidate. Please note that broker-dealers did not have to, under current MSRB interpretations, take this extra precaution in that most state party committees are very large and give to a wide variety of candidates, most of

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[3] One Q&A states that a "dealer would violate Rule G-37 by doing business with an issuer after providing money to any person or entity when the dealer knows that such money will be given to an official of an issuer who could not receive such a contribution directly from the dealer without triggering the rule's prohibition on business." MSRB Q&A III.4 (August 6, 1996)(emphasis added); see also Q&A III.5 (August 6, 1996).

[4] Q&A III.5 states that "[d]ealers should inquire of the non-dealer associated PAC or political party how any funds received from the dealer would be used." (August 6, 1996).

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whom are not issuer officials (e.g., legislative candidates). There would be no reason for broker-dealers to know that their contributions to such state party committees would be used to go to issuer officials even if they did not give to these housekeeping or conference accounts, and thus no indirect contribution would result under the existing Q&As.

The due diligence concepts espoused in the MSRB's proposal are very different from the standards established under the existing Q&As. For example, as described above, the existing Q&As require that a broker-dealer track how its contribution to a party committee or PAC is used (where housekeeping or conference accounts are safe harbors), whereas the proposed Q&As require that broker-dealers look at the expenditures made by the party committee or PAC as a whole. Moreover, the proposal introduces the unprecedented concept of having to somehow reach into the mind of a contributor and pull out the reasons as to why the contribution was made. Given these significant departures from its existing interpretations, the MSRB's claim that it is not changing its standard on party and PAC contributions is unfounded and unduly casts aspersions on an industry which has gone above and beyond taking reasonable steps to comply with the Rule. Thus, we request that the MSRB clarify that these proposed Q&As constitute a new standard on making contributions to party committees and PACs.

3. The Standards in the Proposed Q&As Need to Be Clarified

Even if one were able to boil down the proposed Q&As to the two-pronged standard described in Section 2 above (i.e., the Underlying Reasons Test and the Activity Test), the standard is vague and thus cannot be applied. As a result, broker-dealers and their individual MFPs will, as a practical matter, be forced to shut down contributing any amount to a state or local party committee or PAC, regardless of the circumstances.

This is particularly troublesome given that for most broker-dealers, municipal securities business is only a small part of their total business and they have perfectly legitimate interests completely unrelated to municipal securities business in connection with which they make contributions. Indeed, as one of the most highly regulated industries, a wide variety of legislation, ranging from taxes to banking regulation, impact financial institutions. Broker-dealers have a legitimate and vested interest in supporting party committees to help elect legislators whose positions are good for the industry and the economy. Needless to say, MFPs as voting citizens have even further divergent political interests.

Moreover, unlike the other MSRB Rules, Rules G-37 and G-38 regulate political contributions, which is a form of free speech protected under the

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First Amendment of the Constitution.[5] It is well established that as protected speech, political contributions may not be regulated in a vague or overbroad manner.[6] In particular, unless a restriction on political contributions is clear and precise, it will unduly chill the legitimate exercise of this most important right and violate the Constitution.[7] Such chilling of free speech is exactly what will result from the vague nature of the proposed Q&As in that broker-dealers and MFPs will have to shut down giving to any state or local party committee or PAC because they have no clear standard to apply. Please note the MSRB cannot dismiss this important constitutional concern by simply pointing to the Blount v. SEC case (in which the

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[5] The Courts have equated political contributions with protected First Amendment speech. *See, e.g., Buckley v. Valeo, 424 U.S. 1, 14-15 (1976).*

[6] In *Buckley*, the Supreme Court specifically notes that vagueness is intolerable in laws impacting core First Amendment rights such as political speech. In particular, the Court calls for "[c]lose examination of the specificity of the statutory limitation" in "an area permeated by First Amendment interests." *Buckley*, 424 U.S. at 40-41 (citing *Smith v. Goguen*, 415 U.S. 566, 573 (1974); *Cramp v. Board of Public Instruction*, 368 U.S. 278, 287-288 (1961); *Smith v. California*, 361 U.S. 147, 151 (1959)). *See also FEC v. Christian Action Network*, 110 F.3d 1049, 1051-1052 (4th Cir. 1997). Indeed, "standards of permissible statutory vagueness are strict in the area of free expression." *NAACP v. Button*, 371 U.S. 415, 432 (1963) (citing *Smith v. California*, 361 U.S. 147, 151; *Winters v. New York*, 333 U.S. 507, 509-510, 517-518; *Herndon v. Lowry*, 301 U.S. 242; *Stromberg v. California*, 283 U.S. 359; *United States v. C.I.O.*, 335 U.S. 106, 142 (Rutledge, J., concurring)). *Buckley* also maintains that the application of a statute must "afford the '[p]recision of regulation [that] must be the touchstone in an area so closely touching our most precious freedoms.'" *Buckley*, 424 U.S. at 41 (quoting *NAACP v. Button*, 371 U.S. at 438). The Supreme Court also stated that "[b]ecause First Amendment freedoms need breathing space to survive, government may regulate in the area only with narrow specificity." *NAACP v. Button*, 371 U.S. 415, 433 (1963).

[7] Regarding vague applications of law, the Court in *Buckley* warned of:

> ...not only "trap[ping] the innocent by not providing fair warning" or foster[ing] "arbitrary and discriminatory application" but also operat[ing] to inhibit protected expression by inducing "citizens to 'steer far wider of the unlawful zone... than if the boundaries of the forbidden areas were clearly marked.'" *Grayned v. City of Rockford*, 408 U.S. 104, 108-109 (1972), quoting *Baggett v. Bullitt*, 377 U.S. 360, 372 (1964), quoting *Speiser v. Randall*, 357 U.S. 513, 526 (1958).

Buckley, 424 U.S. at 41 n.48. *See also NAACP v. Button*, 371 U.S. at 433 (noting that the perils of vagueness and overbreadth stem from "the danger of tolerating, in the area of First Amendment freedoms, the existence of a penal statute susceptible of sweeping and improper application"); *Kolender v. Lawson*, 461 U.S. 352, 357-358 (1983).

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court upheld the constitutionality of Rule G-37) given that the decision was based on a Rule that allowed contributions to party committees and PACs.

If the MSRB's intent is to absolutely eliminate state and local party committee and PAC contributions, it should come out and do so with a clear prohibition rather than through a vague interpretation that casts uncertain doubt on all contributions.[8] Alternatively, the MSRB should clarify the Underlying Reasons Test and the Activity Test to give clear guidance as to what is prohibited.

a. The Reasons Test

Although the Underlying Reasons Test requires that broker-dealers determine and keep records of the reasons for making a contribution, it does not provide clear guidance as to what reasons are permissible and what reasons are not. For example, it is not uncommon for a company to contribute unsolicited annual dues to a state party committee as part of an ongoing commitment, under which it has been giving the same amount to that party committee for decades. Would this be an impermissible reason for contributing? To avoid such confusion and vagueness, we recommend that the Underlying Reasons Test be clarified to only cover contributions to party committees and PACs that are controlled by, or where the contribution is solicited by, an issuer official.

Unless the Underlying Reasons Test is clarified to be limited to such particular actions, it will be unconstitutional. Indeed, the courts have repeatedly made clear that political activity may not be regulated based on intent. The Constitution does not permit a regulator to look at a person's intent on a fact-by-fact basis in determining whether his or her political activity violated a particular law -- an exercise in mind-reading that is inappropriate in light of the vagueness and overbreadth requirements impacting First Amendment freedoms.[9] Again, such

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[8] Please note, however, that prohibiting contributions to state and local party committees or PACs is also fraught with constitutional problems. Indeed, it would be an overbroad restriction on First Amendment speech. Moreover, it would also violate the First Amendment right to association in that many party committees (especially local party committees) require voters to pay regular dues in the form of contributions to participate in that party committee's core functions. For example, to be able to vote for an endorsement by Washington State's 43rd District local Democratic Party, an individual must be a dues paying member of that local party. Thus, by prohibiting contributions (i.e., dues) to such party committee, an individual would be unduly restricted in his or her ability to associate with others and engage in core party activities.

[9] Indeed, a speaker cannot be left "'wholly at the mercy of the varied understanding of his hearers and consequently of whatever inference may be drawn as to his intent and meaning.'" *Buckley*, 424 U.S. at 43 (quoting *Thomas v. Collins*, 323 U.S. 516, 535 (1945)).

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regulation of political contributions leads to an unacceptable chilling of protected speech. In confirming the unconstitutionality of an intent-based regulation of political activity, the Eighth Circuit stated:

> Questions of intent ... are to be excluded from the analysis, since a speaker, in such circumstances, could not safely assume how anything he might say would be understood by others...When a definition depends on the meaning others attribute to the speech, there is no security for free discussion.[10]

b. The Activity Test

The Activity Test requires that a broker-dealer ensure that the party committee or PAC (as a whole and not just the account to which the contribution is made) does not "raise money to support one or a limited number of issuer officials." This language is unclear in that it could mean one of two things. One possible reading is that if a contribution is made to a party committee or PAC that supports even one issuer official, then an indirect ban is triggered. Under this strict reading, even a contribution to a national party committee (such as the Republican National Committee or Democratic National Committee), which raises hundreds of millions of dollars primarily to support non-issuer official federal candidates, would be prohibited if that party committee spends even one dollar on an issuer official.

The second possible reading is that one must look at the party committee's or PAC's expenditures and determine whether its expenditures on issuer officials constitute a large enough of a portion of its total expenditures. Essentially, it is a dilution standard to determine whether the broker-dealer would have reason to believe that its contribution is going to directly or indirectly help issuer officials. Under this reading, contributions to national party committees and federal leadership PACs would generally be permitted.

It is highly unlikely that the proposed Q&As were intended to have the former strict meaning. Indeed, the other due diligence requirements in the

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See also Perry v. Bartlett, 231 F.3d 155, 161 (4th Cir. 2000) (striking down an intent-based statute as unconstitutionally overbroad: "[d]iscerning the 'intent' of an organization...can be problematic, even if some in the organization 'admit' their intent").

[10] *Iowa Right to Life Committee v. Williams*, 187 F.3d 963, 969 (8th Cir. 1999) (citing *Buckley*, 424 U.S. at 43, and noting the notice problems that accompany an intent-based regulation).

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proposed Q&As would be superfluous if that were the case given that no party committee or PAC would be permissible. Consequently, the MSRB should confirm the Activity Test as being the dilution standard described above where a broker-dealer may rely on assurances from a party committee or PAC that it uses an acceptable portion of its funds on non-issuer officials. However, for broker-dealers to be able to apply this dilution standard, the MSRB must clarify at what point a party committee or PAC gives to enough non-issuer officials to avoid an indirect ban. For example, is it enough that 50%, 60% or 70% of a state party committee's expenditures are used for non-issuer officials? Moreover, to be able to make this calculation, the MSRB must clarify the time period over which one would look to determine the percentage and regarding which the party committee or PAC would provide its assurances.

4. National Party Committees and Federal Leadership PACs Should Be Expressly Permitted

As described above, contributions to national party committees and federal leadership PACs appear to be permitted under the due diligence standards established by the proposed Q&As. Indeed, national party committees raise hundreds of millions of dollars primarily for non-issuer official federal candidates, and thus are more than sufficiently diluted. Moreover, federal leadership PACs are controlled by an incumbent U.S. Senator or Representative to contribute to his or her colleagues in Congress or to other federal candidates.

Thus, for the sake of simplicity, the MSRB should expressly state that contributions made to a national party committee or federal leadership PAC are permitted under the proposed Q&As as long as (1) the contribution was not solicited by an issuer official, and (2) the party committee or leadership PAC is not controlled by an issuer official. If they do not satisfy both of the above requirements, a broker-dealer would have to take whatever due diligence steps that ultimately become effective for such contributions.

5. The Prohibition on Soliciting Contributions to State and Local Party Committees Should Be Modified

As described above, the MSRB proposes prohibiting the solicitation of contributions on behalf of state and local party committees altogether, while ostensibly permitting contributions to be made to such party committees pursuant to the due diligence requirements described above. It does not make any sense to impose a greater, absolute prohibition on soliciting contributions than on making contributions. Indeed, the act of soliciting contributions does not pose a greater threat of pay-to-play than making contributions. This is recognized under Rule G-

THE BOND MARKET ASSOCIATION

37's current language in that the prohibitions on making and soliciting contributions are co-extensive (i.e., broker-dealers and MFPs are prohibited from making or soliciting contributions to issuer officials). The same approach should be taken in the proposed amendment by permitting broker-dealers and MFPs to solicit contributions on behalf of state and local party committees to the same extent they are allowed to make contributions to them.

6. The Term Affiliated PAC Should Be Clarified

The proposed Q&As suggest that a broker-dealer establish an informational barrier between it and its "affiliated PAC" if that PAC gives to issuer officials. Although this is the first time that Rule G-37 brings in the concept of an "affiliated PAC," the MSRB does not clarify what it means. For example, does it mean a PAC controlled by a wholly-owned affiliate or is partial ownership enough? Given that companies could have varying degrees of ownership in other companies without having any influence over their day-to-day decisions, the MSRB should clarify "affiliated PAC" to mean a PAC that is controlled by a wholly-owned affiliate of the broker-dealer.

We look forward to discussing these issues further with the MSRB staff, and appreciate your attention to our comments. Please contact the undersigned at 646.637.9230 or via e-mail at lnorwood@bondmarkets.com with any questions that you might have.

Sincerely,

Leslie M. Norwood
Vice President and
Assistant General Counsel

cc: ***Securities and Exchange Commission***
The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Giovanni P. Prezioso, General Counsel, Office of the General Counsel
Annette L. Nazareth, Director, Division of Market Regulation
Martha Mahan Haines, Director, Office of Municipal Securities

THE BOND MARKET ASSOCIATION

NASD Regulation, Inc.
Malcolm P. Northam, Director, Fixed Income Securities Regulation
Marc Menchel, General Counsel
Sharon K. Zackula, Assistant General Counsel

Municipal Securities Rulemaking Board
Christopher A. Taylor, Executive Director
Diane G. Klinke, General Counsel

The Bond Market Association
Executive Committee, Municipal Securities Division
Legal Advisory Committee, Municipal Securities Division
Policy Committee, Municipal Securities Division
Rule G-37 Working Group, Municipal Securities Division
Government Relations Committee
Regional Advisory Committee

Griffin, Kubik, Stephens
&Thompson, Inc.

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March 30, 2005

Carolyn Walsh, Esq.
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

RE: MSRB Notice 2005-11—Rule G-37

Dear Ms. Walsh:

We have specific concerns with the thrust of the proposed amendments to and interpretations of Rule G-37. Unfortunately, the proposed amendments would add to what we see as fundamental flaws in G-37 in general, making it difficult to decide the beginning point of our commentary, which we will nonetheless attempt.

We have opposed the concept of G-37 from its very conception as an infringement upon First Amendment rights. We continue to believe that the Rule is blatantly unconstitutional both as to its substance and its promulgation by an administrative body as opposed to being enacted by Congress. There are numerous means available to correct any perceived abuses in the awarding of municipal business without restricting the ability of U.S. citizens to participate in the political process.

Our specific comments are related. The latest proposed amendments and interpretations make use of the term *"affiliated entity of the broker, dealer or municipal securities dealer"* and *"affiliated PACs"* without offering definitional guidance. Even if one does not agree that the basic structure of G-37 is unconstitutional, it is undeniable that it *does* touch upon constitutional freedoms and therefore ought to be extraordinarily specific. Further, regulatory zeal to ferret out *"indirect"* violations must be tempered with the knowledge that there are related entities to broker-dealers that have nothing whatsoever to do with the municipal business. It must be made clear that representatives of those entities have not given up their constitutional rights because of an affiliation with a securities dealer that is in the municipal business. Our reading of G-37 tells us that if one of those related representatives would happen to introduce us to a potential source of municipal finance business while at the same time making political contributions to an official of a completely different local political body, the broker-dealer could face a G-37 compliance problem. If the MSRB proposes to regulate such tenuous connections, it should at least define them specifically; potentially affected parties would be forewarned and clarity would allow constitutional measurement.

While we enthusiastically agree that *"pay to play"* has no place in the awarding of municipal finance business, we question both the propriety and effectiveness of the MSRB's tactics to date. The very fact that the Rule (G-37) seems to require constant expansion and amendment testifies to the inefficiency of this approach.

We would respectfully suggest that full and immediate disclosure ***required of the recipient*** (a web posting seems quite feasible) would be more effective in policing this arena. The NASD, bank regulators, and state and federal criminal authorities clearly have authority to take action in cases that involve influence peddling or outright bribery. It seems more logical to focus attention on those (comparatively few) municipal officials who might abuse their office, than to truncate the constitutional rights of an ever-expanding universe of individuals connected – however remotely – to a municipal securities dealer.

Sincerely,

David M. Thompson
President

Robert J. Stracks
Counsel

/mew

Securities Industry Association
1425 K Street, NW • Washington, DC 20005-3500 • (202) 216-2000 • Fax (202) 216-2119

Marc E. Lackritz
President

April 5, 2005

Carolyn Walsh, Esq.
Senior Associate General Counsel
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Alexandria, Virginia 22314

RE: Comments to Rule G-37 Interpretations

Dear Ms. Walsh:

The Securities Industry Association ("SIA") [1] appreciates the opportunity to comment on the Municipal Securities Rulemaking Board's ("MSRB's") proposed Questions and Answers ("Q&As") regarding the application of Rule G-37 to contributions to political party committees and PACs. MSRB Notice 2005-11 (February 15, 2005). According to this Notice, the Q&As establish new due diligence standards to ensure that broker-dealers do not indirectly contribute to officials of issuers by giving to political party committees or PACs.

The SIA supports the purpose of Rule G-37 to prohibit any form of pay-to-play in the municipal securities industry whether it be direct or indirect contributions to issuer officials. Nevertheless, the proposed due diligence standards are so vague that they are impossible to apply. Thus, we request that they be clarified, as described below.

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1 The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

1. The Q&As Are Vague

The Q&As do not provide clear, or even reasonably clear, guidance upon which broker-dealers may base their day-to-day activity. For example, the Q&As state that a broker-dealer should identify and keep records of the reasons as to why a particular contribution to a party committee or PAC was made, but do not give any guidance as to which specific reasons are permissible and which are not. Obviously, making a contribution for the purpose of influencing an issuer's selection of an underwriter would be impermissible. However, the overwhelming majority of cases do not involve such clear or problematic reasons. Indeed, a broker-dealer may be making a contribution in the form of an ongoing annual dues payment to a party committee or to support legislative candidates who are supportive of certain legislation. Moreover, an individual MFP may want to support a party committee because of his or her party affiliation or the wide variety of social issues supported by that party. The proposed Q&As do not provide any guidance for cases involving these and other benign reasons.

The Q&As also state that the party committee or PAC in question should not "raise money to support one or a limited number of issuer officials." Although the meaning of this language is unclear, it appears to require a broker-dealer to look at what portion of a party committee's or PAC's total expenditures is spent on issuer officials. However, there is no guidance as to what percentage would trigger an indirect ban under Rule G-37.

2. The Q&As Should Be Clarified

For the proposed standards to be workable, the above vagueness must be clarified with bright-line guidance with respect to any party committee or PAC (federal, state or local). Indeed, such clear guidance is mandated by the First Amendment of the Constitution, which prohibits the regulation of any form of protected free speech (including political contributions) in a vague or overbroad manner.

However, providing clarification and certainty is particularly important when it comes to national party committees and federal leadership PACs. Specifically, regardless of how one were to read the proposed due diligence standards, they appear to permit contributions to national party committees and federal leadership PACs. National party committees raise hundreds of millions of dollars primarily to support federal candidates. Thus, the portion of their total expenditures that may go to issuer officials is very insignificant. As for federal

leadership PACs, they are controlled by incumbent U.S. Senators or Representatives to contribute to their colleagues in Congress or to other federal candidates.

Moreover, although broker-dealers have many legitimate reasons for giving to state and local party committees, as described above, this is even more the case when it comes to national party committees and federal leadership PACs. Indeed, broker-dealers have an interest in supporting national party committees and federal leadership PACs to help elect Congressmen and a President whose positions are good for the industry and the economy.[2] This is just as important as directly supporting non-issuer official federal candidates, which is permitted under Rule G-37. Being politically active at the federal level is essential to broker-dealers given that they are one of the most highly regulated industries, and are subject to a wide variety of legislation ranging from taxes to banking regulation.

Despite the legitimacy and apparent permissibility of these federal contributions, the vagueness of the Q&As cast an undue cloud over contributions to any party committee or PAC, no matter how benign. Thus, to avoid any uncertainty, the MSRB should create a safe-harbor from the two-year ban for contributions made to a national party committee or federal leadership PAC. To avoid even the appearance of an indirect violation, the MSRB could, if it wishes, limit this safe-harbor to situations where the contribution was not solicited by an issuer official and where the party committee or leadership PAC is not controlled by an issuer official.

We look forward to working with the MSRB staff regarding these issues. Please call us with any questions.

Sincerely,

Marc E. Lackritz

Marc E. Lackritz
President

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2 Please note that the Federal Election Campaign Act of 1971, as amended, prohibits corporate contributions at the federal level. Thus, broker-dealers may only contribute to national party committees and federal leadership PACs by using its federal PAC, which is funded solely by employee contributions.

cc: **Securities and Exchange Commission**
The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Giovanni P. Prezioso, General Counsel, Office of the General Counsel
Annette L. Nazareth, Director, Division of Market Regulation
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April 1, 2005

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RE: Comments to Proposed Amendments to and Interpretations of Rule G-37

Dear Ms. Walsh:

UBS Financial Services Inc. (the "Firm") appreciates this opportunity to respond to the notice ("Notice") issued by the Municipal Securities Rulemaking Board ("MSRB") on February 15, 2005, in which the MSRB proposed an amendment to Rule G-37 and certain Questions and Answers ("Q&As") regarding the ability of broker-dealers and municipal finance professionals ("MFPs") to make and solicit contributions to political party and PAC committees. The Firm has an interest in this Rule as it is one of the most active participants in the municipal securities industry ("Industry"), and indeed last year was the top-ranked Industry underwriter in the United States, managing issuances worth over $46 billion. Additionally, the Firm has an interest in the unintended consequences of the Rule as a diversified broker-dealer with several affiliated companies.

The Firm has consistently supported the elimination of pay-to-play practices. We further support the MSRB's efforts to close any loopholes that may be used to make contributions that dealers may reasonably foresee will make their way to issuer officials.

The Firm joins The Bond Market Association ("TBMA") comments concerning the Notice, detailed in TBMA's written response to the MSRB's request for comments. For all the reasons expressed in those comments, the Firm requests that the MSRB (1) clarify the proposed Q&As as they relate to contributions to party committees and PACs so that they establish clear standards upon which the industry may rely; (2) acknowledge that the proposed Q&As reflect a new approach to Rule G-37's prohibition on indirect contributions and not just a restatement of some existing standard; (3) exempt from these proposed Q&As contributions made to national party committees and certain federal leadership PACs (controlled by members of Congress), given the lack of a nexus between these federal entities and state and local issuer officials; (4) modify the prohibition on soliciting contributions to a state or local party committee so that broker-dealers and MFPs would be permitted to solicit contributions to the same extent they are able to make a contribution to them; and (5) clarify what is meant by "affiliated PAC" for purposes of erecting an informational barrier.

Rule G-37 has been successful in eliminating actual or perceived "pay-to-play" practices in the Industry. Since it was enacted, Rule G-37 has significantly reduced the political contributions made by dealers and their MFPs. As a result, we believe the Rule has significantly reduced, if not eliminated, pay-to-play practices in the Industry. This success comes with a price as the Rule also has the effect of denying certain MFPs' participation in the political process and creating compliance burdens on the Industry. As a result, before the MSRB vastly expands the Rule, we urge that it study the proposed expansion. The serious First Amendment implications implicit in a ban on party and PAC contributions deserve careful consideration and study to establish a rule that is (i) narrowly tailored to address the problem identified, and (ii) clearly drafted and capable of uniform enforcement throughout the Industry. The draft Q&As do not satisfy either of these concerns.

Rule G-37's stated purpose is "to ensure that the high standards and integrity [of the Industry are maintained] to protect investors and the public interest." We applaud that goal and support efforts to advance it. However, G-37 is limited by its terms to political contributions made to issuer officials. The Rule does not encompass other interactions and relationships that could possibly affect the relationship between issuer officials and dealers. The proposed interpretation of the Rule goes beyond the stated goal of G-37 and beyond the regulation of political contributions to issuer officials. Instead, the proposal would restrict thousands of MFPs' contributions that have absolutely no relation to issuer officials. The vagaries in the proposed Q&As would impose new and unwarranted restrictions on Constitutionally protected political activity without any clear indication that such a vast expansion of the Rule is warranted.

A. The Industry Needs a Clear Objective Standard

The Q&As propose a significant expansion of G-37 by suggesting new ways that party and PAC contributions should be treated as indirect contributions to issuer officials. As a result, contributions to parties and PACs by a dealer or its MFPs could result in a ban on conducting municipal securities business. This is a very severe consequence and thus, it is critical that a clear objective standard be applied before such a penalty can be imposed. The Q&As do not create such a standard, but rather creates a subjective standard that would be difficult, if not impossible, to administer.

First, the Notice states that prior to making a contribution to a party or PAC committee, the "dealer should conduct due diligence to identify the reason for making the payment." (emphasis added) To satisfy this criterion a dealer must have a compliance system that is able to determine the subjective motivation of employees and make decisions based on those subjective criteria. Assuming a broker-dealer can design an effective compliance system to ascertain motivation with a fair degree of certainty, the Q&A is unclear because it fails to define the motivation(s) that should result in a contribution being classified as an indirect contribution to an issuer official.

Second, the Q&A requires a dealer to "receive affirmative assurance from the party or PAC that the party or PAC itself does not raise money to support one or a limited number of issuer officials, and the party or PAC does not transfer money to other state or local parties or PACs that support one or a limited number of issuer officials." An expansive reading of this provision could classify virtually every contribution to a party committee and PAC as a contribution that could cause a ban on business. This language raises serious questions: Can the party or PAC committee adequately assure a dealer that its contributions are not indirectly being given to an issuer official if the committee generally supports only federal candidates but supported one candidate who qualifies as an issuer official? What if it supported an issuer official in the past, but is not presently supporting any issuer officials? Is a party or PAC committee required to conduct the required due diligence with respect to other committees to whom it contributes? Does the language in the Rule regarding "transfers" mean that the committee to which the dealer or MFP makes a contribution must get assurances that none of the committees to which it in turn makes contributions have contributed to any issuer officials? This test would be virtually impossible for any party committee to administer or any dealer to enforce.

Previously, there was a clear test, which has been utilized since it was agreed between the Industry and the Securities and Exchange Commission in connection with the Voluntary Initiative, that required dealers and their MFPs to follow their money, to get assurances that their money would not be contributed to issuer officials. It was possible to administer this standard and to take steps to prevent broker-dealer and MFP money from being contributed to issuer officials. Now, the MSRB has replaced the clear test with a vague and uncertain standard that puts a dealer at risk of a possible ban on business if it or its MFPs make any contributions to party or PAC committees. Yet, it is not necessary to prohibit all party and PAC contributions to effect the purpose of G-37. While there may be party committee and PAC contributions that are in reality indirect contributions to issuer officials, there are clearly some party and PAC committees which do not act as a conduit for issuer officials. National party committees and federal PACs clearly fall into the latter category. The Rule should recognize that some level of tangential "support" is too remote to justify prohibiting MFPs from contributing to all party committees and PACs. Rule G-37 prohibits contributions to issuer officials, and absent political contributions being made by a dealer or MFP to an official of an issuer, the Rule should not attempt to regulate the subjective relationship between elected officials and political committees or between elected officials and dealers.

The ambiguity in the proposed Q&As will create uneven standards and behavior within the Industry. The lack of a clear standard in the proposed Q&As has already produced varying interpretations and effects. Based on the ambiguities in the Notice, the Firm has at least temporarily suspended all party committee and PAC contributions by the Firm, its PAC and MFPs, based on the difficulties of establishing an effective compliance system to implement the vague standard. We understand that other firms have established compliance systems pursuant to which certain contributions can be made to certain national party committees and federal PACs. This fact alone demonstrates that the vague and subjective standard established by the Q&As is particularly susceptible to uneven interpretation and application.

B. First Amendment Concerns

This Rule implicates the First Amendment rights of the Firm's MFPs, including both their speech rights and their rights of association. MFPs have the right to speak, in the form of making political contributions. MFPs also have the right to associate with political party organizations. In many cases, affiliation involves the payment of dues or other moneys to the party committee. The interpretation Rule G-37 promulgated in the Notice could prohibit such payments, regardless of amount or reasons, if the party committee supports an issuer official or contributes money to another organization that supports an issuer official. To implement this policy, are dealers required to enact compliance systems that prohibit all MFPs from joining all political parties that at any level directly or indirectly support one or a limited number of issuer officials? Should a dealer prohibit contributions to national party committees? Should dealers ban contributions to federal leadership PACs and other federal PACs, even if there is no nexus between those federal entities and state and local issuer officials? Should dealers ban employee MFPs from joining a party organization if they are required to pay dues to join?

C. The Rule Amendment Prohibiting Solicitation Should Be Symmetrical to the Contributions Ban

The Notice proposes an amendment to Rule G-37 that would completely prohibit MFPs from soliciting contributions to any state and local party committees. However, the Q&As interpreting the Rule permit MFPs to make contributions to party and PAC committees pursuant to certain due diligence requirements. It is illogical to impose a greater prohibition on soliciting contributions than on making contributions. By definition, if an MFP is permitted to make a contribution to a political committee, that contribution is not an indirect contribution to an official of an issuer. Under such circumstances, what is the basis to prohibit MFP solicitations on behalf of that committee? Currently, Rule G-37's prohibitions on making and soliciting contributions are symmetrical -- broker-dealers and MFPs are prohibited from making or soliciting contributions to issuer officials. The same approach should be taken in the proposed amendment by permitting broker-dealers and MFPs to solicit contributions on behalf of state and local party committees to the same extent they are allowed to make contributions to such committees.

Conclusion

Based on these concerns, the Firm believes that the expansion of the Rule suggested in the Notice should take the form of an amendment to the Rule that sets objective and symmetrical standards for the regulation of political contributions and solicitations. The MSRB should not accomplish a new ban by reinterpreting existing G-37 language and attempting to classify contributions to certain types of committees as indirect contributions to issuer officials. The Firm urges the MSRB to establish a clear and reasonable standard to review party committee and PAC contributions before it imposes any new G-37 restrictions arising from such contributions.

The standard advanced by the MSRB should include objective criteria, including, for example, a reasonable "dilution standard." A clear dilution standard would need to include at least the following elements: (1) a threshold -- 50%, 60% or 70% -- of a party committee or PAC's expenditures used for non-issuer official purposes that would be sufficient to overcome a presumption that the committee supported one or a limited number of issuer officials, and (2) a time period over which the party committee or PAC would be required to examine when calculating the threshold percentage. Such a test would be tailored to address the purposes of G-37 – to eliminate contributions to issuer officials – while avoiding an overbroad law that unduly restricts participation in the political process that it protected by the First Amendment. A clear and reasonable dilution test would have the additional benefit of equal and consistent application in the Industry.

Thank you for soliciting comments as a part of the MSRB's review of the Rule. Please do not hesitate to call me with any questions, or if I can be of any further assistance.

Respectfully submitted,

Terry L. Atkinson
Managing Director
Manager, Municipal Securities Group

cc: Leslie M. Norwood
The Bond Market Association
Vice President and
Assistant General Counsel