

# Rule G-17 Conduct of Municipal Securities and Municipal Advisory Activities



## **INTERPRETIVE NOTICE CONCERNING THE APPLICATION OF MSRB RULE G-17 TO UNDERWRITERS OF MUNICIPAL SECURITIES - March 31, 2021**

Under Rule G-17 of the Municipal Securities Rulemaking Board (MSRB), brokers, dealers, and municipal securities dealers (“dealers”) must, in the conduct of their municipal securities activities, deal fairly with all persons and must not engage in any deceptive, dishonest, or unfair practice. This rule is most often cited in connection with duties owed by dealers to investors; however, it also applies to their interactions with other market participants, including municipal entities<sup>[1]</sup> such as states and their political subdivisions that are issuers of municipal securities (“issuers”).

The MSRB has previously observed that Rule G-17 requires dealers to deal fairly with issuers.<sup>[2]</sup> With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>[3]</sup> the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, in 2012, the MSRB provided additional interpretive guidance that addressed how Rule G-17 applies to dealers acting in the capacity of underwriters in the municipal securities transactions described therein (the “2012 Interpretive Notice”).<sup>[4]</sup>

This notice supersedes the MSRB’s 2012 Interpretive Notice, dated August 2, 2012, concerning the application of Rule G-17 to underwriters of municipal securities, as well as the related implementation guidance, dated July 18, 2012, and frequently-asked questions, dated March 25, 2013 (the “prior guidance”).<sup>[5]</sup> The prior guidance will remain applicable to underwriting relationships commencing prior to March 31, 2021. Underwriters will be subject to the amended guidance provided by this notice for all of their underwriting relationships beginning on or after that date. For purposes of this notice, an underwriting relationship is considered to have begun at the time the delivery of the first disclosure is triggered as described under “Timing and Manner of Disclosures” below (*i.e.*, the earliest stages of an underwriter’s relationship with an issuer with respect to an issue, such as in a response to a request for proposal or in promotional materials provided to an issuer).

### **Applicability of the Notice**

Except where a competitive underwriting is specifically mentioned, this notice applies to negotiated underwritings only.<sup>[6]</sup> This notice does not apply to a dealer acting as a primary distributor in a continuous offering of municipal fund securities, such as interests in 529 savings plans and Achieving a Better Life Experience (ABLE) programs. It does not apply to selling group members. This notice does not address a dealer’s duties when the dealer is serving as an advisor to a municipal entity. This notice applies to a primary offering of a new issue of municipal securities that is placed with investors by a dealer serving as placement agent, although certain disclosures may be omitted as described below.

The fair practice duties outlined in this notice are those duties that a dealer owes to a municipal entity when the dealer underwrites a new issue of municipal securities. This notice does not set out the underwriter’s fair-practice duties to other parties to a municipal securities financing (*e.g.*, conduit borrowers). The MSRB notes, however, that Rule G-17 does require that an underwriter deal fairly with all persons in the course of the dealer’s municipal

securities activities. What actions are considered fair will, of necessity, be dependent on the nature of the relationship between a dealer and such other parties, the particular actions undertaken, and all other relevant facts and circumstances. Although this notice does not address what an underwriter's fair-dealing duties may be with respect to other parties, it may serve as one of many bases for an underwriter to consider how to establish appropriate policies and procedures for ensuring that it meets such fair-practice obligations, in light of its relationship with such other participants and their particular roles.

The examples discussed in this notice are illustrative only and are not meant to encompass all obligations of dealers to municipal entities under Rule G-17. Furthermore, when municipal entities are customers<sup>[7]</sup> of dealers, they are subject to the same protections under MSRB rules, including Rule G-17, that apply to other customers.<sup>[8]</sup> The MSRB notes that an underwriter has a duty of fair dealing to investors in addition to its duty of fair dealing to issuers. An underwriter also has a duty to comply with other MSRB rules as well as other federal and state securities laws.

### **Basic Fair Dealing Principle**

As noted above, Rule G-17 precludes a dealer, in the conduct of its municipal securities activities, from engaging in any deceptive, dishonest, or unfair practice with any person, including an issuer. The rule contains an anti-fraud prohibition. Thus, an underwriter must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with a municipal issuer. However, Rule G-17 does not merely prohibit deceptive conduct on the part of the dealer; it also establishes a general duty of a dealer to deal fairly with all persons (including, but not limited to, issuers), even in the absence of fraud.

### **Role of Underwriters and Conflicts of Interest**

In negotiated underwritings, underwriters' Rule G-17 duty to deal fairly with an issuer requires certain disclosures to the issuer in connection with an issue or proposed issue of municipal securities, as provided below.<sup>[9]</sup>

- The disclosures discussed under "Disclosures Concerning the Underwriters' Role" and "Disclosures Concerning Underwriters' Compensation" (the "standard disclosures") must be provided by the sole underwriter or the syndicate manager<sup>[10]</sup> to the issuer as described below.
- The disclosures discussed under "Required Disclosures to Issuers" (the "transaction-specific disclosures") must be provided to the issuer by the underwriter who has recommended a financing structure or product to the issuer as described below.<sup>[11]</sup>
- The disclosures discussed under "Other Conflicts Disclosures" (the "dealer-specific disclosures") must be provided by the sole underwriter or each underwriter in a syndicate (as applicable) as described below.<sup>[12]</sup>

**Disclosures Concerning the Underwriter's Role.** The sole underwriter or the syndicate manager<sup>[13]</sup> must disclose to the issuer that:

- (i) Municipal Securities Rulemaking Board Rule G-17 requires an underwriter to deal fairly at all times with both issuers and investors;
- (ii) the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer;<sup>[14]</sup>
- (iii) unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests;<sup>[15]</sup>
- (iv) the issuer may choose to engage the services of a municipal advisor with a fiduciary obligation to represent the issuer's interests in the transaction;

- (v) the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable; and
- (vi) the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.<sup>[16]</sup>

Underwriters also must not recommend that issuers not retain a municipal advisor. Accordingly, underwriters may not discourage issuers from using a municipal advisor or otherwise imply that the hiring of a municipal advisor would be redundant because the sole underwriter or underwriting syndicate can provide the services that a municipal advisor would.

**Disclosure Concerning the Underwriters' Compensation.** The sole underwriter or syndicate manager must disclose to issuers whether underwriting compensation will be contingent on the closing of a transaction. Sole underwriters or syndicate managers must also disclose that compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest, because it may cause underwriters to recommend a transaction that is unnecessary or to recommend that the size of a transaction be larger than is necessary.

**Other Conflicts Disclosures.** The sole underwriter or each underwriter in a syndicate must also, when and if applicable, disclose other dealer-specific actual material conflicts of interest and potential material conflicts of interest, <sup>[17]</sup> including, but not limited to, the following:

- (i) any payments described below under "Conflicts of Interest/Payments to or from Third Parties";<sup>[18]</sup>
- (ii) any arrangements described below under "Conflicts of Interest/Profit-Sharing with Investors";
- (iii) the credit default swap disclosures described below under "Conflicts of Interest/Credit Default Swaps"; and
- (iv) any incentives for the underwriter to recommend a complex municipal securities financing and other associated conflicts of interest (as described below under "Required Disclosures to Issuers").<sup>[19]</sup>

These categories of conflicts of interest are not mutually exclusive and, in some cases, a specific conflict may reasonably be viewed as falling into two or even more categories. An underwriter making disclosures of dealer-specific conflicts of interest to an issuer should concentrate on making them in a complete and understandable manner and need not necessarily organize them according to the categories listed above, particularly if adhering to a strict categorization process might interfere with the clarity and conciseness of disclosures.

Where there is a syndicate, each underwriter in the syndicate has a duty to provide its dealer-specific disclosures to the issuer. In general, dealer-specific disclosures for one dealer cannot be satisfied by disclosures made by another dealer (e.g., the syndicate manager) because such disclosures are, by their nature, not uniform, and must be prepared by each dealer. However, a syndicate manager may deliver each of the dealer-specific disclosures to the issuer as part of a single package of disclosures, as long as it is clear to which dealer each disclosure is attributed. An underwriter in the syndicate is not required to notify an issuer if it has determined that it does not have any dealer-specific disclosures to make. However, the obligation to provide dealer-specific disclosures includes material conflicts of interest arising after the time of engagement with the issuer, as noted below.

**Timing and Manner of Disclosures.** The standard disclosures, transaction-specific disclosures, and dealer-specific disclosures must be made in writing to an official of the issuer identified by the issuer as a primary contact for that issuer for the receipt of the foregoing disclosures. In the absence of such identification, an underwriter may make such disclosures in writing to an official of the issuer that the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter and that, to the knowledge of the underwriter, is not a party to a disclosed conflict.<sup>[20]</sup> If provided within the same document as the dealer-specific disclosures and/or transaction-specific disclosures, the standard disclosures must be identified clearly as such and provided apart from the other disclosures (e.g., in an appendix).

Disclosures must be made in a clear and concise manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer in accordance with the following timelines.

- A sole underwriter or syndicate manager must make the standard disclosure concerning the arm's-length nature of the underwriter-issuer relationship at the earliest stages of the underwriter's relationship with the issuer with respect to an issue (e.g., in a response to a request for proposals or in promotional materials provided to an issuer).[21]
- A sole underwriter or syndicate manager must make the other standard disclosures regarding the underwriter's role and compensation at or before the time the underwriter is engaged to perform underwriting services (e.g., in an engagement letter), not solely in a bond purchase agreement.
- An underwriter must make the dealer-specific disclosures at or before the time the underwriter has been engaged to perform the underwriting services.[22] Thereafter, an underwriter must make any applicable dealer-specific disclosures discovered or arising after being engaged as an underwriter as soon as practicable after being discovered and with sufficient time for the issuer to fully evaluate any such conflict and its implications.[23]
- An underwriter who recommends a financing structure or product to an issuer must make the transaction-specific disclosures in sufficient time before the execution of a commitment by an issuer (which may include a bond purchase agreement) relating to the financing, and with sufficient time to allow the issuer to fully evaluate the features of the financing.

Unless directed otherwise by an issuer, an underwriter may update selected portions of disclosures previously provided so long as such updates clearly identify the additions or deletions and are capable of being read independently of the prior disclosures.[24]

**Acknowledgement of Disclosures.** When delivering a disclosure, the underwriter must attempt to receive written acknowledgement[25] from an official of the issuer identified by the issuer as a primary contact for the issuer's receipt of the foregoing disclosures.[26] In the absence of such identification, an underwriter may seek acknowledgement from an official of the issuer whom the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter and that, to the knowledge of the underwriter, is not party to a disclosed conflict. This notice does not specify the particular form of acknowledgement, but may include, for example, an e-mail read receipt.[27] An underwriter may proceed with a receipt of a written acknowledgement that includes an issuer's reservation of rights or other self-protective language. If the official of the issuer agrees to proceed with the underwriting engagement after receipt of the disclosures but will not provide written acknowledgement of receipt, the underwriter responsible for making the requisite disclosure may proceed with the engagement after documenting with specificity why it was unable to obtain such written acknowledgement. Additionally, an underwriter must be able to produce evidence (including, for example, by automatic e-mail delivery receipt) that the disclosures were delivered with sufficient time for evaluation by the issuer before proceeding with the transaction. An issuer's written acknowledgement of the receipt of disclosure is not dispositive of whether such disclosures were made with an appropriate amount of time. The analysis of whether disclosures were provided with sufficient time for an issuer's review is based on the totality of the facts and circumstances.

## **Representations to Issuers**

All representations made by underwriters to issuers in connection with municipal securities underwritings, whether written or oral, must be truthful and accurate and must not misrepresent or omit material facts. Underwriters must have a reasonable basis for the representations and other material information contained in documents they prepare and must refrain from including representations or other information they know or should know is inaccurate or misleading. For example, in connection with a certificate signed by the underwriter that will be relied upon by the issuer or other relevant parties to an underwriting (e.g., an issue price certificate), the dealer must have a reasonable basis for the representations and other material information contained therein.[28] In addition, an underwriter's response to an issuer's request for proposals or qualifications must fairly and accurately describe the underwriter's

capacity, resources, and knowledge to perform the proposed underwriting as of the time the proposal is submitted and must not contain any representations or other material information about such capacity, resources, or knowledge that the underwriter knows or should know to be inaccurate or misleading.[29] Matters not within the personal knowledge of those preparing the response (e.g., pending litigation) must be confirmed by those with knowledge of the subject matter. An underwriter must not represent that it has the requisite knowledge or expertise with respect to a particular financing if the personnel that it intends to work on the financing do not have the requisite knowledge or expertise.

## **Required Disclosures to Issuers**

Many municipal securities are issued using financing structures that are routine and well understood by the typical municipal market professional, including most issuer personnel that have the lead responsibilities in connection with the issuance of municipal securities. For example, absent unusual circumstances or features, the typical fixed rate offering may be presumed to be well understood. Nevertheless, in the case of issuer personnel that the underwriter reasonably believes lack the requisite knowledge or experience to fully understand or assess the implications of a financing structures or products recommended by an underwriter, the underwriter making such recommendation must provide disclosures on the material aspects of such financing structures or product that it recommends (*i.e.*, the “transaction-specific disclosures”).[30]

In some cases, issuer personnel responsible for the issuance of municipal securities would not be well positioned to fully understand or assess the implications of a recommended financing structure in its totality, because it is structured in a unique, atypical, or otherwise complex manner or incorporates unique, atypical, or otherwise complex features or products (a “complex municipal securities financing”).[31] Examples of complex municipal securities financings include, but are not limited to, variable rate demand obligations (“VRDOs”), financings involving derivatives (such as swaps), and financings in which interest rates are benchmarked to an index (such as LIBOR, SIFMA, or SOFR).[32] When a recommendation regarding a complex municipal securities financing structure has been made by an underwriter in a negotiated offering,[33] the underwriter making the recommendation has an obligation under Rule G-17 to communicate more particularized transaction-specific disclosures than those that may be required in the case of the recommendation of routine financing structures or products.[34] The underwriter making the recommendation must also disclose the material financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure.[35] It must also disclose any incentives for the recommendation of the complex municipal securities financing and other associated material conflicts of interest.[36] Such disclosures must be made in a fair and balanced manner based on principles of fair dealing and good faith.

The level of transaction-specific disclosure required may vary according to the issuer’s knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing structure or product, and financial ability to bear the risks of the recommended financing structure or product, in each case based on the reasonable belief of the underwriter.[37] Consequently, the level of transaction-specific disclosure to be provided to a particular issuer also can vary over time. In all events, the underwriter must disclose any incentives for the recommendation of the complex municipal securities financing and other associated conflicts of interest.

As previously mentioned, the transaction-specific disclosures must be made in writing to an official of the issuer identified by the issuer as a primary contact for the issuer for the receipt of such disclosures, or, in the absence of such identification, an underwriter may make such disclosures in writing to an issuer official whom the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter(s), and that, to the knowledge of the underwriter delivering the disclosure, is not a party to a disclosed conflict: (i) in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation (including consultation with any of its counsel or advisors) and (ii) in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer.

The disclosures concerning a complex municipal securities financing must address the specific elements of, and/or relevant products incorporated, into the recommended financing structure, rather than being general in nature.[38]

An underwriter making a Complex Municipal Securities Financing Recommendation to an issuer cannot satisfy its fair dealing obligations by providing an issuer a single document setting out general descriptions of the various financing structures and/or products that may be recommended from time to time to various issuer clients that would effectively require issuer personnel to discover which disclosures apply to a particular recommendation and to the particular circumstances of that issuer. Underwriters can create, in anticipation of making such a recommendation, individualized descriptions, with appropriate levels of detail, of the material financial characteristics and risks for each of the various complex municipal securities financing structures and/or products (including any typical variations) they may recommend from time to time to various issuer clients, with such standardized descriptions serving as the base for more particularized disclosures for the specific complex financing the underwriter recommends to particular issuers.<sup>[39]</sup> In making a recommendation, an underwriter could incorporate, to the extent applicable, any refinements to the base description needed to fully describe the material financial features and risks unique to that financing.<sup>[40]</sup>

If the underwriter who has made a recommendation does not reasonably believe that the official to whom the disclosures are addressed is capable of independently evaluating the disclosures, the underwriter must make additional efforts reasonably designed to inform the official or its employees or agent. The underwriter also must make an independent assessment that such disclosures are appropriately tailored to the issuer's level of sophistication.

### **Underwriter Duties in Connection with Issuer Disclosure Documents**

Underwriters often play an important role in assisting issuers in the preparation of disclosure documents, such as preliminary official statements and official statements.<sup>[41]</sup> These documents are critical to the municipal securities transaction, because investors rely on the representations contained in such documents in making their investment decisions. Moreover, investment professionals, such as municipal securities analysts and ratings services, rely on the representations in forming an opinion regarding the credit. A dealer's duty to have a reasonable basis for the representations it makes, and other material information it provides, to an issuer and to ensure that such representations and information are accurate and not misleading, as described above, extends to representations and information provided by the underwriter in connection with the preparation by the issuer of its disclosure documents (e.g., cash flows).

### **Underwriter Compensation and New Issue Pricing**

**Excessive Compensation.** An underwriter's compensation for a new issue (including both direct compensation paid by the issuer and other separate payments, values, or credits received by the underwriter from the issuer or any other party in connection with the underwriting), in certain cases and depending upon the specific facts and circumstances of the offering, may be so disproportionate to the nature of the underwriting and related services performed as to constitute an unfair practice with regard to the issuer that it is a violation of Rule G-17. Among the factors relevant to whether an underwriter's compensation is disproportionate to the nature of the underwriting and related services performed, are the credit quality of the issue, the size of the issue, market conditions, the length of time spent structuring the issue, and whether the underwriter is paying the fee of the underwriter's counsel or any other relevant costs related to the financing.

**Fair Pricing.** The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced.<sup>[42]</sup> In general, a dealer purchasing bonds in a competitive underwriting for which the issuer may reject any and all bids will be deemed to have satisfied its duty of fairness to the issuer with respect to the purchase price of the issue as long as the dealer's bid is a bona fide bid (as defined in MSRB Rule G-13)<sup>[43]</sup> that is based on the dealer's best judgment of the fair market value of the securities that are the subject of the bid. In a negotiated underwriting, the underwriter has a duty under Rule G-17 to negotiate in good faith with the issuer. This duty includes the obligation of the dealer to ensure the accuracy of representations made during the course of such negotiations, including representations regarding the price negotiated and the nature of investor demand for the securities (e.g., the status of the order period and the order book). If, for example, the dealer represents to the issuer that it is providing the "best" market price available on

the new issue, or that it will exert its best efforts to obtain the “most favorable” pricing, the dealer may violate Rule G-17 if its actions are inconsistent with such representations.<sup>[44]</sup>

## Conflicts of Interest

**Payments to or from Third Parties.** In certain cases, compensation received by an underwriter from third parties, such as the providers of derivatives and investments (including affiliates of an underwriter), may color the underwriter’s judgment and cause it to recommend products, structures, and pricing levels to an issuer when it would not have done so absent such payments. The MSRB views the failure of an underwriter to disclose to the issuer the existence of payments, values, or credits received by an underwriter in connection with its underwriting of the new issue from parties other than the issuer, and payments made by the underwriter in connection with such new issue to parties other than the issuer (in either case including payments, values, or credits that relate directly or indirectly to collateral transactions integrally related to the issue being underwritten), to be a violation of an underwriter’s obligation to the issuer under Rule G-17.<sup>[45]</sup> For example, it would be a violation of Rule G-17 for an underwriter to compensate an undisclosed third party in order to secure municipal securities business. Similarly, it would be a violation of Rule G-17 for an underwriter to receive undisclosed compensation from a third party in exchange for recommending that third party’s services or product to an issuer, including business related to municipal securities derivative transactions. This notice does not require that the amount of such third-party payments be disclosed. The underwriter must also disclose to the issuer whether it has entered into any third-party arrangements for the marketing of the issuer’s securities.

**Profit-Sharing with Investors.** Arrangements between the underwriter and an investor purchasing new issue securities from the underwriter (including purchases that are contingent upon the delivery by the issuer to the underwriter of the securities) according to which profits realized from the resale by such investor of the securities are directly or indirectly split or otherwise shared with the underwriter also would, depending on the facts and circumstances (including in particular if such resale occurs reasonably close in time to the original sale by the underwriter to the investor), constitute a violation of the underwriter’s fair dealing obligation under Rule G-17.<sup>[46]</sup> Such arrangements could also constitute a violation of Rule G-25(c), which precludes a dealer from sharing, directly or indirectly, in the profits or losses of a transaction in municipal securities with or for a customer. An underwriter should carefully consider whether any such arrangement, regardless of whether it constitutes a violation of Rule G-25 (c), may evidence a potential failure of the underwriter’s duty with regard to new issue pricing described above.

**Credit Default Swaps.** The issuance or purchase by a dealer of credit default swaps for which the reference is the issuer for which the dealer is serving as underwriter, or an obligation of that issuer, may pose a conflict of interest, including a dealer-specific conflict of interest, because trading in such municipal credit default swaps has the potential to affect the pricing of the underlying reference obligations, as well as the pricing of other obligations brought to market by that issuer. Rule G-17 requires, therefore, that a dealer disclose the fact that it engages in such activities to the issuers for which it serves as underwriter. Activities with regard to credit default swaps based on baskets or indexes of municipal issuers that include the issuer or its obligation(s) need not be disclosed, unless the issuer or its obligation(s) represents more than 2% of the total notional amount of the credit default swap or the underwriter otherwise caused the issuer or its obligation(s) to be included in the basket or index.

## Retail Order Periods

Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to, in fact, honor such agreement.<sup>[47]</sup> A dealer that wishes to allocate securities in a manner that is inconsistent with an issuer’s requirements must not do so without the issuer’s consent. In addition, Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to take reasonable measures to ensure that retail clients are bona fide. An underwriter that knowingly accepts an order that has been framed as a retail order when it is not (e.g., a number of small orders placed by an institutional investor that would otherwise not qualify as a retail customer) would violate Rule G-17 if its actions are inconsistent with the issuer’s expectations regarding retail orders. In addition, a dealer that places an order that is framed as a qualifying retail order but in fact represents an order that does not meet the qualification requirements to be treated as a retail order (e.g., an order by a retail dealer without “going away” orders<sup>[48]</sup> from retail customers, when such orders are not within the issuer’s definition of “retail”)

violates its Rule G-17 duty of fair dealing. The MSRB will continue to review activities relating to retail order periods to ensure that they are conducted in a fair and orderly manner consistent with the intent of the issuer and the MSRB's investor protection mandate.

## **Dealer Payments to Issuer Personnel**

Dealers are reminded of the application of MSRB Rule G-20, on gifts, gratuities, and non-cash compensation, and Rule G-17, in connection with certain payments made to, and expenses reimbursed for, issuer personnel during the municipal bond issuance process.<sup>[49]</sup> These rules are designed to avoid conflicts of interest and to promote fair practices in the municipal securities market.

Dealers should consider carefully whether payments they make in regard to expenses of issuer personnel in the course of the bond issuance process, including in particular, but not limited to, payments for which dealers seek reimbursement from bond proceeds or issuers, comport with the requirements of Rule G-20. For example, a dealer acting as a financial advisor or underwriter may violate Rule G-20 by paying for excessive or lavish travel, meal, lodging and entertainment expenses in connection with an offering (such as may be incurred for rating agency trips, bond closing dinners, and other functions) that inure to the personal benefit of issuer personnel and that exceed the limits or otherwise violate the requirements of the rule.<sup>[50]</sup>

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<sup>[1]</sup> For purposes of this notice, the term “municipal entity” is used as defined by Section 15B(e)(8) of the Securities Exchange Act of 1934 (the “Exchange Act”), 17 CFR 240.15Ba1-1(g), and other rules and regulations thereunder.

<sup>[2]</sup> See Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities, MSRB Notice 2009-54 (September 29, 2009); Rule G-17 Interpretive Letter – Purchase of new issue from issuer, MSRB interpretation of December 1, 1997, reprinted in MSRB Rule Book (“1997 Interpretation”).

<sup>[3]</sup> Pub. L. No. 111-203 § 975, 124 Stat. 1376 (2010).

<sup>[4]</sup> See Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (Aug. 2, 2012) (superseded upon the effective date of this notice as described below).

<sup>[5]</sup> See [MSRB Notice 2012-38](#) (July 18, 2012); [MSRB Notice 2013-08](#) (Mar. 25, 2013).

<sup>[6]</sup> The MSRB has always viewed competitive offerings narrowly to mean new issues sold by the issuer to the underwriter on the basis of the lowest price bid by potential underwriters – that is, the fact that an issuer publishes a request for proposals and potential underwriters compete to be selected based on their professional qualifications, experience, financing ideas, and other subjective factors would not be viewed as representing a competitive offering for purposes of this notice. In light of this meaning of the term “competitive underwriting,” it should be clear that, although most of the examples relating to misrepresentations and fairness of financial aspects of an offering consist of situations that would only arise in a negotiated offering, Rule G-17 should not be viewed as allowing an underwriter in a competitive underwriting to make misrepresentations to the issuer or to act unfairly in regard to the financial aspects of the new issue.

<sup>[7]</sup> MSRB Rule D-9 defines the term “customer” as follows: “Except as otherwise specifically provided by rule of the Board, the term ‘Customer’ shall mean any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities.”

<sup>[8]</sup> See MSRB Reminds Firms of Their Sales Practice and Due Diligence Obligations When Selling Municipal Securities in the Secondary Market, MSRB Notice 2010-37 (September 20, 2010).

<sup>[9]</sup> For purposes of this notice, underwriters are only required to provide written disclosure of their applicable conflicts and are not required to make any written disclosures on the part of issuer personnel or any other parties to the transaction as part of the standard disclosures, dealer-specific disclosures, or the transaction-specific disclosures.

<sup>[10]</sup> For purposes of this notice, the term “syndicate manager” refers to the lead manager, senior manager, or

bookrunning manager of the syndicate. In circumstances where an underwriting syndicate is formed, only that single syndicate manager is obligated to make the standard disclosures under this notice. In the event that there are joint-bookrunning senior managers, only one of the joint-bookrunning senior managers would be obligated under this notice to make the standard disclosures. Unless otherwise agreed to, such as pursuant to an agreement among underwriters, the joint-bookrunning senior manager responsible for maintaining the order book of the syndicate would be responsible for providing the standard disclosures. Notwithstanding the fair dealing obligation of a syndicate manager to deliver the standard disclosures under this notice, nothing herein would prohibit an underwriter from making a disclosure in order to, for example, comply with another regulatory or statutory obligation.

[11] Where an underwriting syndicate is formed, the syndicate manager has the sole responsibility hereunder for providing the standard disclosures. Consistent with this obligation placed on the syndicate manager, only the syndicate manager must maintain and preserve records of the standard disclosures in accordance with MSRB rules. Further, the MSRB acknowledges that an underwriter may not know if a syndicate will form at the time that certain disclosures are sent. In instances in which an underwriter has provided a standard disclosure prior to or concurrent with the formation of a syndicate, it shall suffice that the then-underwriter (later syndicate manager) has delivered a standard disclosure, and no affirmative statement is necessary that a disclosure is being made on behalf of any existing or future syndicate members for the syndicate manager to have met its fair dealing obligations in this regard. Notwithstanding the obligation of a syndicate manager to deliver the standard disclosures, nothing herein would prohibit, or should be construed as prohibiting, another underwriter from delivering a standard disclosure in order to, for example, comply with another regulatory or statutory obligation.

[12] Each underwriter, whether a sole underwriter, syndicate manager, or other member of the underwriting syndicate, has a fair dealing obligation under this notice to deliver transaction-specific disclosures where such underwriter has made a recommendation to an issuer regarding a financing structure or product. The fair dealing obligation to deliver such a transaction-specific disclosure, includes, but is not limited to, determining the level of disclosure required based on the type of financing structure or product recommended and a reasonable belief of the issuer's knowledge and experience regarding that particular type of financing structure or product. In such cases, as further discussed below, a sole underwriter, syndicate manager, or other member of the underwriting syndicate who has not made such a recommendation would not need to deliver transaction-specific disclosures in order to meet its fair dealing obligation under this notice.

[13] See also note 30 *infra*.

[14] As a threshold matter, the disclosures delivered by an underwriter to an issuer must not be inaccurate or misleading, and nothing in this notice should be construed as requiring an underwriter to make a disclosure to an issuer that is false. For example, in a private placement where a dealer acting as an agent to place securities on behalf of an issuer does not take a principal position (including not taking a "riskless principal" position) in the securities being placed, the standard disclosure relating to an "arm's length" relationship may be inapplicable and in such case may be omitted due to the agent-principal relationship between the dealer and issuer that commonly gives rise to other duties as a matter of common law or another statutory or regulatory regime – whether termed as a fiduciary or other obligation of trust. See Exchange Act Release No. 66927 (May 4, 2012), 77 FR 27509 (May 10, 2012) (SR-MSRB-2011-09). In certain other contexts, depending on the specific facts and circumstances, a dealer acting as an underwriter may take on, either through an agency arrangement or other purposeful understanding, a fiduciary relationship with the issuer. In such case, it would be appropriate for an underwriter to omit those disclosures deemed inapplicable as a result of such relationship.

A dealer acting as a placement agent in the primary offering of a new issuance of municipal securities should also consider how the scope of its activities may interact with the registration and record-keeping requirements for municipal advisors adopted by the Securities and Exchange Commission (the "Commission") under Section 15B of the Exchange Act (15 U.S.C. 78o-4), including the application of the exclusion from the definition of "municipal advisor" applicable to a dealer acting as an underwriter pursuant to Exchange Act Rule 15Ba1-1(d)(2)(i). See Registration of Municipal Advisors, Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67467 (hereinafter, the "MA Rule Adopting Release"), at 67515 – 67516 (November 12, 2013) (available at <http://www.sec.gov/rules/final/2013/34-70462.pdf>) (stating: "The Commission does not believe that the underwriter exclusion should be limited to a particular type of underwriting or a particular type of offering. Therefore, if a registered broker-dealer, acting as a placement

agent, performs municipal advisory activities that otherwise would be considered within the scope of the underwriting of a particular issuance of municipal securities as discussed [therein], the broker-dealer would not have to register as a municipal advisor.”); see *also* the MA Rule Adopting Release, 78 FR at 67513 – 67514 (discussing activities within and outside the scope of serving as an underwriter of a particular issuance of municipal securities for purposes of the underwriter exclusion).

[15] *Id.*

[16] In many private placements, as well as in certain other types of new issue offerings, no official statement may be produced, so that, to the extent that such an offering occurs without the production of an official statement, a dealer would not be required to disclose its role with regard to the review of an official statement.

[17] For purposes hereof, a potential material conflict of interest must be disclosed if, but only if, it is *reasonably likely* to mature into an actual material conflict of interest during the course of the transaction between the issuer and the underwriter.

[18] The third-party payments to which the disclosure standard would apply are those that give rise to actual material conflicts of interest or potential material conflicts of interest only.

[19] The specific standard with respect to complex financings does not obviate a dealer’s fair dealing obligation to disclose the existence of payments, values, or credits received by the underwriter or of other material conflicts of interest in connection with any negotiated underwriting, whether it be complex or routine.

[20] Absent red flags, an underwriter may reasonably rely on a written statement from an issuer official that he or she is not a party to a disclosed conflict. The reasonableness of an underwriter’s reliance on such a written statement will depend on all the relevant facts and circumstances, including the facts revealed in connection with the underwriter’s due diligence in regards to the transaction generally or in determining whether the underwriter itself has any actual material conflicts of interest or potential material conflicts of interest that must be disclosed.

[21] See *also* note 30 *infra*.

[22] In offerings where a syndicate is formed, the disclosure obligation for an underwriter to make its dealer-specific disclosures is triggered – if any such actual material conflicts of interest or potential material conflicts of interest must be so disclosed – when such underwriter becomes engaged as a member of the underwriting syndicate (except with regard to conflicts discovered or arising after such co-managing underwriter has been engaged). Consistent with the obligation of sole underwriters and syndicate managers, each underwriter in the syndicate must make any applicable dealer-specific disclosures discovered or arising after being engaged as an underwriter in the syndicate as soon as practicable after being discovered and with sufficient time for the issuer to fully evaluate such a conflict and its implications.

[23] For example, an actual material conflict of interest or potential material conflict of interest may not be present until an underwriter has recommended a particular financing structure. In that case, the disclosure must be provided in sufficient time before the execution of a contract with the underwriter to allow the issuer official to fully evaluate the recommendation, as described under “Required Disclosures to Issuers.”

[24] The MSRB acknowledges that not all transactions proceed along the same timeline or pathway. The timeframes expressed herein should be viewed in light of the overarching goals of Rule G-17 and the purposes that the disclosures are intended to serve as further described in this notice. The various timeframes set out in this notice are not intended to establish strict, hair-trigger tripwires resulting in mere technical rule violations, so long as an underwriter *acts* in substantial compliance with such timeframes and meets the key objectives for providing disclosure under the notice. Nevertheless, an underwriter’s fair dealing obligation to an issuer in particular facts and circumstances may demand prompt adherence to the timelines set out in this notice. Stated differently, if an underwriter does not timely deliver a disclosure and, as a result, the issuer: (i) does not have clarity throughout all substantive stages of a financing regarding the roles of its professionals, (ii) is not aware of conflicts of interest promptly after they arise and well before the issuer effectively becomes fully committed – either formally (*e.g.*, through execution of a contract) or informally (*e.g.*, due to having already expended substantial time and effort ) – to completing the transaction with the underwriter, and/or (iii) does not have the information required to be disclosed

with sufficient time to take such information into consideration and, thereby, to make an informed decision about the key decisions on the financing, then the underwriter generally will have violated its fair-dealing obligations under Rule G-17, absent other mitigating facts and circumstances.

[25] An underwriter delivering a disclosure in order to meet a fair dealing obligation must obtain (or attempt to obtain) proper acknowledgement. When there is an underwriting syndicate, only the syndicate manager, as the dealer responsible for delivering the standard disclosures to the issuer, must obtain (or attempt to obtain) proper acknowledgement from the issuer for such disclosures.

[26] Absent red flags, and subject to an underwriter's ability to reasonably rely on a representation from an issuer official that he or she has the authority to bind the issuer by contract with the underwriter, an underwriter may reasonably rely on a written delegation by an authorized issuer official in, among other things, the issuer's request for proposals to another issuer official to receive and acknowledge receipt of a disclosure. The reasonableness of an underwriter's reliance upon an issuer's representation as to these matters will depend on all of the relevant facts and circumstances, including the facts revealed in connection with the underwriter's due diligence in regards to the transaction generally.

[27] For purposes of this notice, the term "e-mail read receipt" means an automatic response generated by a recipient issuer official confirming that an e-mail has been opened. While an e-mail read receipt may generally be an acceptable form of an issuer's written acknowledgement under this notice, an underwriter may not rely on such an e-mail read receipt as an issuer's written acknowledgement where such reliance is unreasonable under all of the facts and circumstances, such as where the underwriter is on notice that the issuer official to whom the e-mail is addressed has not in fact received or opened the e-mail.

[28] The need for underwriters to have a reasonable basis for representations and other material information provided to issuers extends to the reasonableness of assumptions underlying the material information being provided. If an underwriter would not rely on any statements made or information provided for its own purposes, it should refrain from making the statement or providing the information to the issuer, or should provide any appropriate disclosures or other information that would allow the issuer to adequately assess the reliability of the statement or information before relying upon it. Further, underwriters should be careful to distinguish statements made to issuers that represent opinion rather than factual information and to ensure that the issuer is aware of this distinction.

[29] As a general matter, a response to a request for proposal should not be treated as merely a sales pitch without regulatory consequence, but instead should be treated with full seriousness that issuers have the expectation that representations made in such responses are true and accurate.

[30] In the circumstance where a dealer proposing to act as an underwriter in a negotiated offering recommends a financing structure or product prior to the time at which an underwriting syndicate is formed, such dealer shall have the same obligations to make any applicable standard disclosures, as if it were a sole underwriter or syndicate manager for purposes of the obligations described under "Required Disclosure to the Issuer" (e.g., to make the standard disclosure concerning the arm's-length nature of the underwriter-issuer relationship at the earliest stages of the underwriter's relationship with the issuer with respect to an issue), including complying with corresponding requirements to maintain and preserve records.

[31] If a complex municipal securities financing consists of an otherwise routine financing structure that incorporates a unique, atypical, or complex element or product and the issuer personnel have knowledge or experience with respect to the routine elements of the financing, the disclosure of material risks and characteristics may be limited to those relating to such specific element or product and any material impact such element or product may have on other features that would normally be viewed as routine.

[32] Respectively, the London Inter-bank Offered Rate (*i.e.*, "LIBOR"), the SIFMA Municipal Swap Index (*i.e.*, "SIFMA"), and Secured Overnight Financing Rate ("SOFR"). The MSRB notes that its references to LIBOR, SIFMA, and SOFR are illustrative only and non-exclusive. Any financings involving a benchmark interest rate index may be complex, particularly if an issuer is unlikely to fully understand the components of that index, its material risks, or its possible interaction with other indexes.

[33] For purposes of determining when an underwriter recommends a financing structure in a negotiated offering or

recommends a complex municipal securities financing in a negotiated offering (a “Complex Municipal Securities Financing Recommendation”), the MSRB’s guidance on the meaning of “recommendation” for dealers in MSRB Notice 2014-07: SEC Approves MSRB Rule G-47 on Time-of-Trade Disclosure Obligations, MSRB Rules D-15 and G-48 on Sophisticated Municipal Market Professionals, and Revisions to MSRB Rule G-19 on Suitability of Recommendations and Transactions (March 12, 2014) is applicable by analogy. For example, whether an underwriter has made a Complex Municipal Securities Financing Recommendation is not susceptible to a bright line definition but turns on the facts and circumstances of the particular situation. An important factor in determining whether a Complex Municipal Securities Financing Recommendation has been made is whether – given its content, context, and manner of presentation— a particular communication from an underwriter to an issuer regarding a financing structure or product reasonably would be viewed as a call to action or reasonably would influence an issuer to engage in a such a financing structure or product deemed a complex municipal securities financing structure. In general, the more individually tailored the underwriter’s communication is to a specific issuer about a complex municipal securities financing structure, the greater the likelihood that the communication reasonably would be viewed as a Complex Municipal Securities Financing Recommendation.

[34] An underwriter must make reasonable judgments regarding whether it has recommended a financing structure or product to an issuer and whether a particular financing structure or product recommended by the underwriter to the issuer is complex, understanding that the fact that a structure or product has become relatively common in the market does not reduce its complexity. Not all negotiated offerings involve a recommendation by the underwriter(s), such as where a sole underwriter merely executes a transaction already structured by the issuer or its municipal advisor.

[35] For example, when a Complex Municipal Securities Financing Recommendation for a VRDO is made, the underwriter who recommends a VRDO should inform the issuer of the risk of interest rate fluctuations and material risks of any associated credit or liquidity facilities (e.g., the risk that the issuer might not be able to replace the facility upon its expiration and might be required to repay the facility provider over a short period of time). As an additional example, if the underwriter recommends that the issuer swap the floating rate interest payments on the VRDOs to fixed rate payments under a swap, the underwriter must disclose the material financial risks (including market, credit, operational, and liquidity risks) and material financial characteristics of the recommended swap (e.g., the material economic terms of the swap, the material terms relating to the operation of the swap, and the material rights and obligations of the parties during the term of the swap), as well as the material financial risks associated with the VRDO. Such disclosure should be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financing. Such disclosures must also inform the issuer that there may be accounting, legal, and other risks associated with the swap and that the issuer should consult with other professionals concerning such risks. If the underwriter who has made a Complex Municipal Financing Securities Recommendation is affiliated with the swap dealer proposed to be the executing swap dealer, the underwriter may satisfy its disclosure obligation with respect to the swap if such disclosure has been provided to the issuer by the affiliated swap dealer or the issuer’s swap or other financial advisor that is independent of such underwriter and the swap dealer, as long as the underwriter has a reasonable basis for belief in the truthfulness and completeness of such disclosure. If the issuer decides to enter into a swap with another dealer, the underwriter is not required to make disclosures with regard to that swap product under this notice. The MSRB notes that a dealer who recommends a swap or security-based swap to a municipal entity may also be subject to rules of the Commodity Futures Trading Commission or those of the Securities and Exchange Commission (“SEC”).

[36] For example, a conflict of interest may exist when the underwriter who makes a Complex Municipal Securities Financing Recommendation to an issuer is also the provider, or an affiliate of the provider, of a swap used by an issuer to hedge a municipal securities offering or when an underwriter receives compensation from a swap provider for recommending the swap. See *also* “Conflicts of Interest/Payments to or from Third Parties” herein.

[37] Even a financing in which the interest rate is benchmarked to an index that is commonly used in the municipal marketplace (e.g., SIFMA) may be complex to an issuer that does not understand the components of that index or its possible interaction with other indexes.

[38] See note 19 *supra*.

[39] Page after page of complex legal jargon in small print would not be consistent with an underwriter’s fair dealing

obligation under this notice.

[40] Underwriters should be able to leverage such materials for internal training and risk management purposes.

[41] Underwriters that assist issuers in preparing official statements must remain cognizant of their duties under federal securities laws. With respect to primary offerings of municipal securities, the SEC has noted, “By participating in an offering, an underwriter makes an implied recommendation about the securities.” See Exchange Act Release No. 26100 (Sept. 22, 1988) (proposing Exchange Act Rule 15c2-12) at text following *fn.* 70. The SEC has stated that “this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings.” Furthermore, pursuant to Exchange Act Rule 15c2-12(b)(5), an underwriter may not purchase or sell municipal securities in most primary offerings unless the underwriter has reasonably determined that the issuer or an obligated person has entered into a written undertaking to provide certain types of secondary market disclosure and has a reasonable basis for relying on the accuracy of the issuer’s ongoing disclosure representations. Exchange Act Release No. 34961 (Nov. 10, 1994) (adopting continuing disclosure provisions of Exchange Act Rule 15c2-12) at text following *fn.* 52.

[42] The MSRB has previously observed that whether an underwriter has dealt fairly with an issuer for purposes of Rule G-17 is dependent upon all of the facts and circumstances of an underwriting and is not dependent solely on the price of the issue. See MSRB Notice 2009-54 (Sept. 29, 2009) and the 1997 Interpretation (note 2 *supra*). See also “Retail Order Periods” herein.

[43] Rule G-13(b)(iii) provides: “For purposes of subparagraph (i), a quotation shall be deemed to represent a ‘bona fide bid for, or offer of, municipal securities’ if the broker, dealer or municipal securities dealer making the quotation is prepared to purchase or sell the security which is the subject of the quotation at the price stated in the quotation and under such conditions, if any, as are specified at the time the quotation is made.”

[44] See 1997 Interpretation (note 2 *supra*).

[45] See also “Required Disclosures to Issuers” herein.

[46] Underwriters should be mindful that, depending on the facts and circumstances, such an arrangement may be inferred from a purposeful but not otherwise justified pattern of transactions or other course of action, even without the existence of a formal written agreement.

[47] See [MSRB Interpretation on Priority of Orders for Securities in a Primary Offering under Rule G-17](#), MSRB interpretation of October 12, 2010, reprinted in MSRB Rule Book. The MSRB also reminds underwriters of previous MSRB guidance on the pricing of securities sold to retail investors. See Guidance on Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities, [MSRB Notice 2009-42 \(July 14, 2009\)](#).

[48] In general, a “going away” order is an order for new issue securities for which a customer is already conditionally committed. See Exchange Act Release No. 62715, File No. SR-MSRB-2009-17 (August 13, 2010).

[49] See [MSRB Rule G-20 Interpretation — Dealer Payments in Connection With the Municipal Securities Issuance Process \(January 29, 2007\)](#), reprinted in MSRB Rule Book.

[50] See *In the Matter of RBC Capital Markets Corporation*, Exchange Act Release No. 59439 (Feb. 24, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB Rules G-20 and G-17 for payment of lavish travel and entertainment expenses of city officials and their families associated with rating agency trips, which expenditures were subsequently reimbursed from bond proceeds as costs of issuance); *In the Matter of Merchant Capital, L.L.C.*, Exchange Act Release No. 60043 (June 4, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB rules for payment of travel and entertainment expenses of family and friends of senior officials of issuer and reimbursement of the expenses from issuers and from proceeds of bond offerings).

The MSRB amended Rule G-17, regarding fair dealing, to require that, in the conduct of their municipal advisory activities, municipal advisors, including solicitor municipal advisors, and their associated persons must deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice. (Previously, the rule applied only to dealers and their associated persons.) Rule G-17 became applicable to all municipal advisors, including solicitor municipal advisors, and their associated persons, on December 22, 2010.

Rule G-17 contains an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the SEC under the Exchange Act. Thus, all municipal advisors must refrain from engaging in certain conduct and must not misrepresent or omit the facts, risks, or other material information about municipal advisory activities undertaken. However, Rule G-17 does not merely prohibit deceptive conduct on the part of a municipal advisor. The rule also establishes a general duty of a municipal advisor to deal fairly with all persons, even in the absence of fraud.

Rule G-17 imposes a duty of fair dealing on solicitor municipal advisors when they are soliciting business from municipal entities and obligated persons on behalf of third parties. Again, municipal advisors are reminded that the term “municipal entity” also includes certain entities that do not issue municipal securities. Thus, in addition to owing the specific obligations discussed below to issuers of municipal securities, solicitor municipal advisors also owe such obligations to, for example, state and local government sponsored public pension plans and local government investment pools.

The duty of fair dealing includes, but is not limited to, a duty to disclose to the municipal entity or obligated person being solicited material facts about the solicitation, such as the name of the solicitor's client; the type of business being solicited; the amount and source of all of the solicitor's compensation; payments (including in-kind) made by the solicitor to another solicitor municipal advisor (including an affiliate, but not an employee) to facilitate the solicitation regardless of characterization; and any relationships of the solicitor with any employees or board members of the municipal entity or obligated person being solicited or any other persons affiliated with the municipal entity or obligated person or its officials who may have influence over the selection of the solicitor's client.

Additionally, if a solicitor municipal advisor is engaged by its client to present information about a product or service offered by the third-party client to the municipal entity or obligated person, the solicitor municipal advisor must disclose all material risks and characteristics of the product or service. The solicitor municipal advisor must also advise the municipal entity or obligated person of any incentives received by the solicitor (that are not already disclosed as part of the solicitor municipal advisor's compensation from its client) to recommend the product or service, as well as any other conflicts of interest regarding the product or service, and must not make material misstatements or omissions when discussing the product or service.

Under the Exchange Act, municipal advisors and their associated persons are deemed to owe a fiduciary duty to their municipal entity clients.<sup>[\*]</sup> Similarly, Rule G-42 (which applies only to non-solicitor municipal advisors) follows the Exchange Act in deeming municipal advisors to owe a fiduciary duty, for purposes of Rule G-42, to such municipal entity clients. However, because a solicitor municipal advisor's clients are not the municipal entities that they solicit, but rather the third parties that retain or engage the solicitor municipal advisor to solicit such municipal entities, solicitor municipal advisors do not owe a fiduciary duty under the Exchange Act or MSRB rules to their clients (or the municipal entity) in connection with such activity. Nonetheless, as noted above, solicitor municipal advisors are subject to the fair dealing standards under Rule G-17 (including with respect to their clients and the entities that they solicit).

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<sup>[\*]</sup> See Order Adopting SEC Final Rule [Release No. 34-70462 (September 20, 2013), 78 FR 67467 (November 12, 2013) (File No. S7-45-10)], at n. 100 (noting that the fiduciary duty of a municipal advisor, as set forth in Section 15B (c)(1) of the Exchange Act, extends only to its municipal entity clients).

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## **INTERPRETATION ON PRIORITY OF ORDERS FOR SECURITIES IN A PRIMARY OFFERING UNDER RULE G-17 - October 12, 2010**

On December 22, 1987, the MSRB published a notice<sup>[1]</sup> interpreting the fair practice principles of Rule G-17 as they

apply to the priority of orders for new issue securities (the “1987 notice”). The MSRB wishes to update the guidance provided in the 1987 notice due to changes in the marketplace and subsequent amendments to Rule G-11.

Rule G-11(e) requires syndicates to establish priority provisions and, if such priority provisions may be changed, to specify the procedure for making changes. The rule also permits a syndicate to allow the syndicate manager, on a case-by-case basis, to allocate securities in a manner other than in accordance with the priority provisions if the syndicate manager determines in its discretion that it is in the best interests of the syndicate. Under Rule G-11(f), syndicate managers must furnish information, in writing, to the syndicate members about terms and conditions required by the issuer,<sup>[2]</sup> priority provisions and the ability of the syndicate manager to allocate away from the priority provisions, among other things. Syndicate members must promptly furnish this information, in writing, to others upon request. This requirement was adopted to allow prospective purchasers to frame their orders to the syndicate in a manner that would enhance their ability to obtain securities since the syndicate’s allocation procedures would be known.

In addition to traditional priority provisions found in syndicate agreements, municipal securities underwriters frequently agree to other terms and conditions specified by the issuer of the securities relating to the distribution of the issuer’s securities. Such provisions include, but are not limited to, requirements concerning retail order periods. MSRB Rule G-17 states that, in the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer (“dealer”) shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. These requirements specifically apply to an underwriter’s activities conducted with a municipal securities issuer, including any commitments that the underwriter makes regarding the distribution of the issuer’s securities. An underwriter may violate the duty of fair dealing by making such commitments to the issuer and then failing to honor them. This could happen, for example, if an underwriter fails to accept, give priority to, or allocate to retail orders in conformance with the provisions agreed to in an undertaking to provide a retail order period. A dealer who wishes to allocate securities in a manner that is inconsistent with an issuer’s requirements must not do so without the issuer’s consent.

Except as otherwise provided in this notice, principles of fair dealing will require the syndicate manager to give priority to customer orders over orders for its own account, orders by other members of the syndicate for their own accounts, orders from persons controlling, controlled by, or under common control with any syndicate member (“affiliates”) for their own accounts, or orders for their respective related accounts,<sup>[3]</sup> to the extent feasible and consistent with the orderly distribution of securities in a primary offering. This principle may affect a wide range of dealers and their related accounts given changes in organizational structures due to consolidations, acquisitions, and other corporate actions that have, in many cases, resulted in increasing numbers of dealers, and their related dealer accounts, becoming affiliated with one another.

Rule G-17 does not require the syndicate manager to accord greater priority to customer orders over orders submitted by non-syndicate dealers (including selling group members). However, prioritization of customer orders over orders of non-syndicate dealers may be necessary to honor terms and conditions agreed to with issuers, such as requirements relating to retail orders.

The MSRB understands that syndicate managers must balance a number of competing interests in allocating securities in a primary offering and must be able quickly to determine when it is appropriate to allocate away from the priority provisions, to the extent consistent with the issuer’s requirements. Thus, Rule G-17 does not preclude the syndicate manager or managers from according equal or greater priority to orders by syndicate members for their own accounts, affiliates for their own accounts, or their respective related accounts if, on a case-by-case basis, the syndicate manager determines in its discretion that it is in the best interests of the syndicate. However, the syndicate manager shall have the burden of justifying that such allocation was in the best interests of the syndicate. Syndicate managers should ensure that all allocations, even those away from the priority provisions, are fair and reasonable and consistent with principles of fair dealing under Rule G-17.

It should be noted that all of the principles of fair dealing articulated in this notice extend to any underwriter of a primary offering, whether a sole underwriter, a syndicate manager, or a syndicate member.

[1] MSRB Notice of Interpretation Concerning Priority of Orders for New Issue Securities: Rule G-17 (December 22, 1987).

[2] The requirements of Rule G-11(f) with respect to issuer requirements were adopted by the MSRB in 1998. See Exchange Act Release No. 40717 (November 27, 1998) (File No. SR-MSRB-97-15).

[3] “Related account” has the meaning set forth in Rule G-11(a)(xi).

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## **MSRB REMINDS FIRMS OF THEIR SALES PRACTICE AND DUE DILIGENCE OBLIGATIONS WHEN SELLING MUNICIPAL SECURITIES IN THE SECONDARY MARKET - September 20, 2010**

### **Executive Summary**

Brokers, dealers and municipal securities dealers (dealers or firms) must fully understand the bonds they sell in order to meet their disclosure, suitability and pricing obligations under the rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws. These obligations are not limited to firms involved in primary offerings. Dealers must also obtain, analyze and disclose all material facts about secondary market transactions that are known to the dealer, or that are reasonably accessible to the market through established industry sources.

Those sources include, among other things, official statements, continuing disclosures, trade data, and other information made available through the MSRB’s Electronic Municipal Market Access system (EMMA). Firms may also have a duty to obtain and disclose information that is not available through EMMA, if it is material and available through other public sources. The public availability of material information, through EMMA or otherwise, does not relieve a firm of its duty to disclose that information. Firms must also have reasonable grounds for determining that a recommendation is suitable based on information available from the issuer of the security or otherwise. Firms must also use this information to determine the prevailing market price of a security as the basis for establishing a fair price in a transaction with a customer. To meet these requirements, firms must perform an independent analysis of the bonds they sell, and may not rely solely on a bond’s credit rating.

Continuing disclosures made by issuers to the MSRB via EMMA are part of the information that dealers must obtain, disclose and consider in meeting their regulatory obligations. The Securities and Exchange Commission (SEC) has recently approved amendments to Securities Exchange Act Rule 15c2-12, governing continuing disclosures. Firms that sell municipal securities should review and, if necessary, update their procedures to reflect the amendments, which have a compliance date of December 1, 2010.

### **Background and Discussion**

#### ***MSRB Disclosure, Suitability and Pricing Rules***

MSRB Rule G-17 provides that, in the conduct of its municipal securities activities, each dealer must deal fairly with all persons and may not engage in any deceptive, dishonest or unfair practice. The MSRB has interpreted Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale, all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.<sup>[1]</sup> This includes the obligation to give customers a complete description of the security, including a description of the features that likely would be considered significant by a reasonable investor and facts that are material to assessing the potential risks of the investment.

Such disclosures must be made at the “time of trade,” which the MSRB defines as at or before the point at which the investor and the dealer agree to make the trade. Rule G-17 applies to all sales of municipal securities, whether or not a transaction was recommended by a broker-dealer.<sup>[2]</sup> This means that municipal securities dealers must disclose all information required to be disclosed by the rule even if the trade is self-directed.<sup>[3]</sup>

MSRB Rule G-19 requires that a dealer that recommends a municipal securities transaction have reasonable grounds for believing that the recommendation is suitable for the customer based upon information available from the issuer of the security or otherwise and the facts disclosed by, or otherwise known about, the customer.<sup>[4]</sup>

MSRB Rule G-30 requires that dealers trade with customers at prices that are fair and reasonable, taking into consideration all relevant factors.<sup>[5]</sup> The MSRB has stated that the concept of a “fair and reasonable” price includes the concept that the price must “bear a reasonable relationship to the prevailing market price of the security.” The impetus for the MSRB’s Real-time Transaction Reporting System (RTRS), which was implemented in January 2005, was to allow market participants to monitor market price levels on a real-time basis and thus assist them in identifying changes in market prices that may have been caused by news or market events.<sup>[6]</sup> The MSRB now makes the transaction data reported to RTRS available to the public through EMMA.

In meeting these disclosure, suitability and pricing obligations, firms must take into account all material information that is known to the firm or that is available through “established industry sources,” including official statements, continuing disclosures, and trade data, much of which is now available through EMMA. Resources outside of EMMA may include press releases, research reports and other data provided by independent sources. Established industry sources can also include material event notices and other data filed with former nationally recognized municipal securities information repositories (NRMSIRs) before July 1, 2009.<sup>[7]</sup> Therefore, firms should review their policies and procedures for obtaining material information about the bonds they sell to make sure they are reasonably designed to access all material information that is available, whether through EMMA or other established industry sources. The MSRB has also noted that the fact that material information is publicly available through EMMA does not relieve a firm of its duty to specifically disclose it to the customer at the time of trade, or to consider it in determining the suitability of a bond for a specific customer.<sup>[8]</sup> Importantly, the dealer may not simply direct the customer to EMMA to fulfill its time-of-trade disclosure obligations under Rule G-17.<sup>[9]</sup>

### ***Amendments to Rule 15c2-12 Concerning Continuing Disclosure***

Securities Exchange Act Rule 15c2-12 requires underwriters participating in municipal bond offerings that are subject to that rule<sup>[10]</sup> to receive, review, and distribute official statements of issuers of primary municipal securities offerings, and prohibits underwriters from purchasing or selling municipal securities covered by the rule unless they have first reasonably determined that the issuer or an obligated person<sup>[11]</sup> has contractually agreed to make certain continuing disclosures to the MSRB, including certain financial information and notice of certain events. The MSRB makes such disclosure public via EMMA.

Financial information to be disclosed under the rule consists of the following:

- Annual financial information updating the financial information in the official statement;
- Audited financial statements, if available and not included within the annual financial information; and
- Notices of failure to provide such financial information on a timely basis.

Currently, the rule enumerates the following as notice events, if material:

- Principal and interest payment delinquencies;
- Non-payment related defaults;
- Unscheduled draws on debt service reserves reflecting financial difficulties;
- Unscheduled draws on credit enhancements reflecting financial difficulties;
- Substitution of credit or liquidity providers or their failure to perform;
- Adverse tax opinions or events affecting the tax-exempt status of the security;
- Modifications to rights of security holders;
- Bond calls;
- Defeasances;
- Release, substitution or sale of property securing repayment of the securities; and
- Rating changes.

Rule 15c2-12(c) also prohibits any dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive prompt notice of any event notice reported pursuant to the rule. Firms should review any applicable continuing disclosures made available through EMMA and other established industry sources and take such disclosures into account in undertaking its suitability and pricing determinations.

On May 26, 2010, the SEC amended the rule’s disclosure obligations, with a compliance date of December 1, 2010,

to: (1) apply continuing disclosure requirements to new primary offerings of certain variable rate demand obligations (VRDOs); (2) add four new notice events;<sup>[12]</sup> (3) remove the materiality standard for certain notice events;<sup>[13]</sup> and (4) require that event notices be filed in a timely manner but no later than 10 business days after their occurrence. With respect to the tax status of the security, the rule has been broadened to require disclosure of adverse tax opinions, issuance by the IRS of proposed or final determinations of taxability and other material notices, and determinations or events affecting the tax status of the bonds (including a Notice of Proposed Issue). Firms that deal in municipal securities should familiarize themselves with these amendments, and, if necessary, modify their policies and procedures to incorporate this additional disclosure accordingly.

The Financial Industry Regulatory Authority (FINRA) noted in its Regulatory Notice 09-35 that, if a firm discovers through its Rule 15c2-12 procedures or otherwise that an issuer has failed to make filings required under its continuing disclosure agreements, the firm must take this information into consideration in meeting its disclosure obligations under MSRB Rule G-17 and in assessing the suitability of the issuer's bonds under MSRB Rule G-19.

### ***Credit Ratings***

In order to meet their obligations under MSRB Rules G-17 and G-19, firms must analyze and disclose to customers the risks associated with the bonds they sell, including, but not limited to, the bond's credit risk. A credit rating is a third-party opinion of the credit quality of a municipal security. While the MSRB generally considers credit ratings and rating changes to be material information for purposes of disclosure, suitability and pricing, they are only one factor to be considered, and dealers should not solely rely on credit ratings as a substitute for their own assessment of a bond's credit risk. <sup>[14]</sup> Moreover, different agencies use different quantitative and qualitative criteria and methodologies to determine their rating opinions. Dealers should familiarize themselves with the rating systems used by rating agencies in order to understand and assess the relevance of a particular rating to the firm's overall assessment of the bond.<sup>[15]</sup> With respect to credit or liquidity enhanced securities, the MSRB has stated that material information includes the following, if known to the dealer or if reasonably available from established industry sources: (i) the credit rating of the issue or lack thereof; (ii) the underlying credit rating or lack thereof, (iii) the identity of any credit enhancer or liquidity provider; and (iv) the credit rating of the credit provider and liquidity provider, including potential rating actions (e.g., downgrade).<sup>[16]</sup> Additionally, material terms of the credit facility or liquidity facility should be disclosed (e.g., any circumstances under which a standby bond purchase agreement would terminate without a mandatory tender).

### ***Other Material Information***

In addition to a bond's credit quality, firms must obtain, analyze and disclose other material information about a bond, including but not limited to whether the bond may be redeemed prior to maturity in-whole, in-part or in extraordinary circumstances,<sup>[17]</sup> whether the bond has non-standard features that may affect price or yield calculations,<sup>[18]</sup> whether the bond was issued with original issue discount or has other features that would affect its tax status,<sup>[19]</sup> and other key features likely to be considered significant by a reasonable investor. For example, for VRDOs, auction rate securities or other securities for which interest payments may fluctuate, firms should explain to customers the basis on which periodic interest rate resets are determined.<sup>[20]</sup> The MSRB has stated that firms should take particular care with respect to new products that may be introduced into the municipal securities market, existing products that may have complex structures that can differ materially from issue to issue, and outstanding securities that may trade infrequently, may be issued by less well-known issuers, or may have unusual features.<sup>[21]</sup>

### ***Supervision***

Firms are reminded that MSRB Rule G-27 requires firms to supervise their municipal securities business, and to ensure that they have adequate policies and procedures in place for monitoring the effectiveness of their supervisory systems. Specifically, firms must:

- Supervise the conduct of the municipal securities activities of the firm and associated persons to ensure compliance with all MSRB rules, the Exchange Act and the rules there under;
- Have adequate written supervisory procedures; and
- Implement supervisory controls to ensure that their supervisory procedures are adequate.

Rule G-27 requires that a firm's supervisory procedures provide for the regular and frequent review and approval by

a designated principal of customer accounts introduced or carried by the dealer in which transactions in municipal securities are effected, with such review being designed to ensure that transactions are in accordance with all applicable rules and to detect and prevent irregularities and abuses. Although the rule does not establish a specific procedure for ensuring compliance with the requirement to provide disclosures to customers pursuant to Rule G-17, firms should consider including in their procedures for reviewing accounts and transactions specific processes for documenting or otherwise ascertaining that such disclosures have been made.

### **Questions to Consider**

Before selling any municipal bond, dealers should make sure that they fully understand the bonds they are selling in order to make adequate disclosure to customers under Rule G-17, to ensure that recommendations are suitable under Rule G-19, and to ensure that they are fairly priced under Rule G-30. Among other things, dealers should ask and be able to answer the following questions:

- What are the bond's key terms and features and structural characteristics, including but not limited to its issuer, source of funding (e.g., general obligation or revenue bond), repayment priority, and scheduled repayment rate? (Much of this information will be in the Official Statement, which for many municipal bonds can be obtained by entering the CUSIP number in the MuniSearch box at [www.emma.msrb.org](http://www.emma.msrb.org)). Be aware, however, data in the Official Statement may have been superseded by the issuer's on-going disclosures.
- Does information available through EMMA or other established industry sources indicate that an issuer is delinquent in its material event notice and other continuing disclosure filings? Delinquencies should be viewed as a red flag.
- What other public material information about the bond or its issuer is available through established industry sources other than EMMA?
- What is the bond's rating? Has the issuer of the bond recently been downgraded? Has the issuer filed any recent default or other event notices, or has any other information become available through established industry sources that might call into question whether the published rating has been revised to take such event into consideration?
- Is the bond insured, or does it benefit from liquidity support, a letter of credit or is it otherwise supported by a third party? If so, check the credit rating of the bond insurer or other backing, and the bond's underlying rating (without third party support). If supported by a third party, review the terms and conditions under which the third party support may terminate.
- How is it priced? Be aware that the price of a bond can be priced above or below its par value for many reasons, including changes in the creditworthiness of a bond's issuer and a host of other factors, including prevailing interest rates.
- How and when will interest on the bond be paid? Most municipal bonds pay semiannually, but zero coupon municipal bonds pay all interest at the time the bond matures. Variable rate bonds typically will pay interest more frequently, usually on a monthly basis in variable amounts.
- What is the bond's tax status, under both state and federal laws? Is it subject to the Federal Alternate Minimum Tax? Is it fully taxable (e.g., Build America Bonds)?
- What are its call provisions? Call provisions allow the issuer to retire the bond before it matures. How would a call affect expected future income?

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[1] MSRB Rule G-17 applies to all transactions in municipal securities, including those in both the primary and secondary market. MSRB Rule G-32 specifically addresses the delivery of the official statement in connection with primary offerings.

[2] See [MSRB Notice 2009-42 \(July 14, 2009\)](#).

[3] A dealer's specific investor protection obligations, including its disclosure, fair practice and suitability obligations under Rules G-17 and G-19, may be affected by the status of an institutional investor as a Sophisticated Municipal Market Professional ("SMMP"). See [Rule G-17 Interpretation – Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals \(April 30, 2002\)](#).

[4] See [MSRB Notice 2009-42](#), *supra* n.2.

[5] Rule G-18 requires that a dealer effecting an agency trade with a customer make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.

[6] See [MSRB Notice 2004-3 \(January 26, 2004\)](#).

[7] Since July 1, 2009, material event notices are required to be filed through EMMA, which has replaced Bloomberg Municipal Repository; DPC DATA Inc.; Interactive Data Pricing and Reference Data, Inc.; and Standard & Poor's Securities Evaluations, Inc. as the sole NRMSIR.

[8] The MSRB has also stated that providing adequate disclosure does not relieve a firm of its suitability obligations. See [MSRB Notice 2007-17 \(March 30, 2007\)](#).

[9] Rule G-32 does allow a dealer to satisfy its obligation to deliver an official statement to its customer during the primary offering disclosure period no later than the settlement of the transaction by advising the customer of how to obtain it on EMMA, unless the customer requests a paper copy. The delivery obligation under Rule G-32 is distinct from the duty to disclose material information under Rule G-17, which applies to all primary and secondary market transactions.

[10] Certain limited offerings, variable rate demand obligations, and small issues are exempt from Rule 15c2-12.

[11] "Obligated person" is defined as "any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations of the municipal securities to be sold in the offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities)."

[12] The new notice events are (1) tender offers, (2) bankruptcy, insolvency, receivership, or similar events, (3) consummation of mergers, consolidations, acquisitions, or asset sales, or entry into or termination of a definitive agreement related to do the same, if material, and (4) appointment of a successor or additional trustee or a change in the name of the trustee, if material.

[13] The amendments removed the materiality standard and require notices for the following events: (1) principal and interest payment delinquencies with respect to the securities being offered ; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes. The amendments retained the materiality standard for the following events: (1) non-payment related defaults; (2) modifications to rights of security holders; (3) bond calls; and (4) release, substitution, or sale of property securing repayment of the securities.

[14] See [MSRB Notice 2009-42](#), *supra* n.2. Ratings changes are reportable events under Rule 15c2-12.

[15] Not all municipal bonds are rated. While an absence of a credit rating is not, by itself, a determinant of low credit quality, it is a factor that the dealers should consider, and may warrant additional due diligence of the bond and its issuer by the dealer. In addition, MSRB Rule G-15 requires confirmation statements for customer trades in unrated municipal securities to disclose that the securities are not rated.

[16] See [MSRB Notice 2009-42](#). The SEC has approved the MSRB's proposal to require dealers to submit copies of credit enhancement and liquidity facility documents to EMMA pursuant to amended MSRB Rule G-34(c), which may increase the availability of such information to dealers. See Securities Exchange Act Release No. 62755, August 20, 2010 (File No. SR-MSRB-2010-02).

[17] See Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, MSRB Interpretation of March 4, 1986.

[18] See Transactions in Municipal Securities With Non-Standard Features Affecting Price/Yield Calculations, MSRB Interpretation of June 12, 1995.

[19] See [MSRB Notice 2005-01 \(January 5, 2005\)](#); [MSRB Notice 2009-41 \(July 10, 2009\)](#).

[20] See [MSRB Notice 2008-09 \(February 19, 2008\)](#).

[21] See [MSRB Notice 2009-42](#), *supra* n.2.

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## **REMINDER NOTICE ON FAIR PRACTICE DUTIES TO ISSUERS OF MUNICIPAL SECURITIES - September 29, 2009**

The Municipal Securities Rulemaking Board (“MSRB”) has recently provided guidance regarding the fair practice and related obligations of brokers, dealers and municipal securities dealers (“dealers”) to investors.<sup>[1]</sup> Specifically, MSRB Rule G-17, on conduct of municipal securities activities, states that, in the conduct of its municipal securities business, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. The MSRB is publishing this notice to remind dealers that the fair practice requirements of Rule G-17 also apply to their municipal securities activities with issuers of municipal securities.

Thus, the rule requires dealers to deal fairly with issuers in connection with all aspects of the underwriting of their municipal securities, including representations regarding investors made by the dealer. As the MSRB has previously stated, whether or not an underwriter has dealt fairly with an issuer is dependent upon the facts and circumstances of an underwriting and cannot be addressed simply by virtue of the price of the issue.<sup>[2]</sup> The MSRB has also previously noted that Rule G-17 may apply in connection with certain payments made and expenses reimbursed during the municipal bond issuance process for excessive or lavish entertainment or travel expenses.<sup>[3]</sup>

As noted above, the fair practice requirements of Rule G-17 apply to all municipal securities activities of dealers with issuers. In particular, even where other MSRB rules provide for specific disclosures or other actions by, or establish specific standards of behavior for, dealers with respect to or on behalf of issuers, such disclosures, actions or behavior must also comport with the fair practice principles of Rule G-17. The MSRB will continue to review practices with respect to dealer activities with issuers.

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[1] See [MSRB Notice 2009-42 \(July 14, 2009\)](#).

[2] See [Rule G-17 Interpretive Letter – Purchase of new issue from issuer, MSRB interpretation of December 1, 1997](#), reprinted in *MSRB Rule Book*.

[3] See [MSRB Rule G-20 Interpretation — Dealer payments in connection with the municipal securities issuance process, MSRB interpretation of January 29, 2007](#), reprinted in *MSRB Rule Book*.

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## **GUIDANCE ON DISCLOSURE AND OTHER SALES PRACTICE OBLIGATIONS TO INDIVIDUAL AND OTHER RETAIL INVESTORS IN MUNICIPAL SECURITIES - July 14, 2009**

Significant participation by individual investors has long been a hallmark of the municipal securities market and, consequently, a focus of the core investor protection efforts of the Municipal Securities Rulemaking Board (the “MSRB”).<sup>[1]</sup> This Notice reminds brokers, dealers and municipal securities dealers (“dealers”) of their sales practice obligations under MSRB rules as applied specifically to individual and other retail investors. Among other things, this Notice updates guidance to dealers on (i) their obligations to disclose material information about issuers, their securities and credit/liquidity support for such securities in connection with the fulfillment of their disclosure obligations

under MSRB Rule G-17, (ii) their obligations to use such material information in fulfilling their suitability obligations under MSRB Rule G-19, and (iii) their fair pricing obligations under MSRB Rules G-18 and G-30.[2] This Notice also applies previous guidance on bond insurance rating downgrades and wide-scale auction failures for municipal auction rate securities (“ARS”) to municipal securities transactions in general and specifically to transactions with individual and other retail investors in variable rate demand obligations (“VRDOs”).[3]

## **Basic Investor Protection Obligation**

Rule G-17 is the core of the MSRB’s investor protection rules. It provides that, in the conduct of its municipal securities activities, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. The rule contains an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the Securities and Exchange Commission (“SEC”) under the Securities Exchange Act of 1934 (the “Exchange Act”). However, it also establishes a general duty to deal fairly, even in the absence of fraud. This general duty to deal fairly places several specific obligations on dealers with respect to their dealings with their customers, including the obligation to disclose material information, as described below. All activities of dealers must be viewed in light of these basic principles, regardless of whether other MSRB rules establish additional requirements on dealers.

## **Access to Material Information in the Municipal Securities Market**

Many of the investor protection obligations established under MSRB rules are premised on dealer access to material information about municipal securities. Such access is fundamental not only to the ability of a dealer to meet its disclosure obligations to customers under MSRB rules but also to the ability of the dealer to undertake the necessary analyses to determine the suitability of a recommended municipal securities transaction and to determine the prevailing market price in connection with establishing a fair transaction price, among other things.

As professionals in the marketplace, dealers use a combination of internal resources and public and proprietary information sources to obtain the information necessary to conduct their business in a professional manner and to meet their disclosure and fair practice duties to investors. In 2002, the MSRB identified certain “established industry sources” in the municipal securities market that were available to and generally used by dealers that effect transactions in municipal securities.[4] While dealers and some institutional investors could readily access information from the established industry sources directly or through information vendors, most investors (and, in particular, individual investors) did not have ready access to many of the established industry sources and were largely limited to the information they could obtain through dealers.

With the advent of the MSRB’s Electronic Municipal Market Access system (“EMMA”) as a new established industry source, the amount, nature, timing and accessibility of information available to the entire marketplace, including both professionals and individual investors, has changed significantly since 2002. Official statements and other primary market disclosure documents, as well as continuing disclosure documents, are available to the general public through the EMMA web portal. Transaction price information is now available on a real-time basis, and comprehensive interest rate information for VRDOs and ARS also is available for the first time. All of this information is made available to the general public, at no cost, through the EMMA web portal, and also is available through subscription feeds to market participants and information vendors. It is expected that information vendors will continue to make this information available to their clients, together with increasing levels of value added products.

## **Disclosure of Material Information**

**General Disclosure Duty.** Rule G-17 requires a dealer effecting a municipal securities transaction to disclose to its customer all material information about the transaction known by the dealer, as well as material information about the security that is reasonably accessible to the market.[5] Information available from established industry sources is deemed to be reasonably accessible to the market for purposes of this Rule G-17 disclosure obligation. Such disclosures must be made at or prior to the sale of municipal securities to the investor (*i.e.*, when the investor and the dealer agree to make the trade), also referred to as the “time of trade.” This is a key protection mandated by MSRB rules.[6] This disclosure duty applies to any municipal securities transaction, regardless of whether the dealer is acting as a so-called “order-taker” (as when the trade is “unsolicited”), whether the transaction is recommended, or whether the transaction is a primary or secondary market trade.[7] Dealers continue to be obligated to make the required time of trade disclosures to their customers mandated by Rule G-17, notwithstanding the availability to

investors of comprehensive information from EMMA and other established industry sources.

In general, information is considered “material” if there is a substantial likelihood that its disclosure would have been considered important or significant by a reasonable investor.<sup>[8]</sup> The duty to disclose material information to a customer in a municipal securities transaction includes the duty to give a complete description of the security, including a description of the features that likely would be considered significant by a reasonable investor and facts that are material to assessing the potential risks of the investment.<sup>[9]</sup> For VRDOs, ARS or other securities for which interest payments may fluctuate, such material facts would include a description of the basis on which periodic interest rate resets are determined.

The scope of material information that dealers are obligated to disclose to their customers under Rule G-17 is not limited solely to the information made available through established industry sources. Dealers also must disclose material information they know about the securities even if such information is not then available from established industry sources. It is essential that dealers establish procedures reasonably designed to ensure that information known to the dealer is communicated internally or otherwise made available to relevant personnel in a manner reasonably designed to ensure compliance with this disclosure obligation.

**Disclosures with Respect to Credit/Liquidity Enhancement and Ratings.** The MSRB previously has provided guidance on specific disclosures that may be required in connection with insured municipal securities, including in particular insured ratings, underlying ratings and potential rating actions disclosed by the rating agencies.<sup>[10]</sup> The principles enunciated with respect to insured bonds also are generally applicable in connection with any third-party credit enhancement provided with respect to municipal securities, regardless of the type of such enhancement. This disclosure obligation extends to enhancements such as, without limitation, letters of credit, surety bonds, state or federal agency enhancements, and other similar products or programs.

For VRDOs, dealers generally must consider factors relevant to both the long-term nature of the securities as well as short-term liquidity features of such securities. Banks or other financial institutions (collectively, “banks”) may issue letters of credit or similar product (“LOCs”), which provide both long-term credit support (by guaranteeing payment of principal and interest on VRDOs) and short-term liquidity support (by guaranteeing the purchase price of tendered VRDOs). Alternatively, banks may provide only liquidity support for tendered VRDOs, through a standby bond purchase agreement or similar product (“SBPA”). Typically, an SBPA is used when the issuer has a strong credit rating by itself or it is coupled with bond insurance. However, while LOCs are generally irrevocable for the term of the LOC, that is frequently not the case with SBPAs. Some SBPAs are structured so that certain negative credit or other events with regard to the issue or bond insurer result in the immediate termination of the SBPA and the loss of liquidity support, without a prior mandatory tender of the bonds.<sup>[11]</sup> If such an immediate termination event occurs, investors are left holding long-term, floating-rate bonds with no tender right.

The role of the remarketing agent also may be material to investors. If the remarketing agent for a VRDO has customarily or from time-to-time taken tendered bonds into inventory to make it unnecessary to draw on the liquidity facility for unremarketed bonds (thereby in effect providing liquidity support), the fact that the remarketing agent is not contractually obligated to maintain such practice will generally be material information required to be disclosed to customers to which VRDOs are sold.

The following information will generally be material information required to be disclosed to investors in credit/liquidity enhanced securities, including but not limited to VRDOs, if known to the dealer or if reasonably available from established industry sources: (i) the credit rating of the issue or lack thereof; (ii) the underlying credit rating or lack thereof, (iii) the identity of any credit enhancer or liquidity provider; and (iv) the credit rating of the credit provider and liquidity provider, including potential rating actions (e.g., downgrade). Additionally, material terms of the credit facility or liquidity facility should be disclosed (e.g., any circumstances under which an SBPA would terminate without a mandatory tender). This list is not exhaustive. Other information may also be material to investors in credit/liquidity enhanced securities.

### **Other Investor Protection Obligations**

Although disclosure to investors is a key customer protection duty of dealers under MSRB rules, other important customer protection rules also apply. Thus, dealers are reminded that they are not relieved of their suitability

obligations under MSRB Rule G-19 simply by disclosing material information to the customer. They are also not relieved of their fair pricing obligations to their customers under MSRB Rules G-18 and G-30 by disclosing material information to investors. The information known by a dealer in connection with a municipal security, together with the information available from established industry sources, generally should inform the dealer, to the extent applicable, in undertaking the necessary analyses and determinations needed to meet these other customer protection obligations.

**Suitability of Recommendations.** Under MSRB Rule G-19, a dealer that recommends a municipal securities transaction to a customer must have reasonable grounds for believing that the recommendation is suitable, based upon information available from the issuer of the security or otherwise (including from established industry sources) and the facts disclosed by or otherwise known about the customer.<sup>[12]</sup> To assure that a dealer effecting a recommended transaction with an individual investor has the information needed about the investor to make its suitability determination, the rule requires the dealer to make reasonable efforts to obtain information concerning the investor's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation.<sup>[13]</sup>

Dealers are reminded that the obligation arising under Rule G-19 in connection with a recommended transaction requires a meaningful analysis,<sup>[14]</sup> taking into consideration the information obtained about the investor and the security, which establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations are required regardless of the apparent safety of a particular security or issuer or the apparent wealth or sophistication of a particular investor. Suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, and those factors may vary from transaction to transaction. Factors to be considered include, but are not limited to, the investor's financial profile, tax status, investment objectives (including portfolio concentration/diversification), and the specific characteristics and risks of the municipal security recommended to the investor.

The MSRB notes that Section (c) of Exchange Act Rule 15c2-12 provides that it is impermissible for a dealer to recommend the purchase or sale of a municipal security unless the dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of the specified material events that are subject to the continuing disclosure obligations of the rule. A dealer would be expected to have reviewed any applicable continuing disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account in undertaking its suitability determination.

With regard to credit-enhanced securities, facts relating to the credit rating of the credit enhancer may affect suitability determinations, particularly for investors who have conveyed to the dealer investment objectives relating to credit quality of investments. For example, if a customer has expressed the desire to purchase only "triple A" rated securities, recommendations to the customer should take into account information from rating agencies, including information about potential rating actions that may affect the future "triple A" status of the issue. In the case of recommended VRDOs or any other securities that are viewed as providing significant liquidity to investors, a dealer must consider both the liquidity characteristics of the security and the investor's need for a liquid investment when making a suitability determination. Facts relating to the short-term credit rating, if any, of the LOC or SBPA provider, or of any other third-party liquidity facility provider, generally would affect suitability determinations in such securities. To the extent that an investor seeks to invest in VRDOs due to their liquidity characteristics, a suitability analysis also generally would require a dealer, in recommending a VRDO to an individual investor, to consider carefully the circumstances, if any, under which the liquidity feature may no longer be effectively available to the customer.

It is incumbent upon any dealer wishing to market municipal securities to customers that it understand the material features of the security, particularly if such dealer is to fulfill its obligation to undertake a suitability determination in connection with a recommended transaction. Dealers should take particular care with respect to new products that may be introduced into the municipal securities market,<sup>[15]</sup> existing products that may have complex structures that can differ materially from issue to issue, and outstanding securities that may trade infrequently, may be issued by less well-known issuers, or may have unusual features. Dealers are reminded that they must review the relevant disclosure documents to become familiar with the specific characteristics of the product, including the tax features, prior to recommending such products to their customers.

**Fair Pricing.** MSRB Rule G-30(a) establishes the pricing obligation of dealers in principal transactions between dealers and customers. The rule provides that the aggregate transaction price to the customer must be fair and reasonable, taking into consideration all relevant factors. A “fair and reasonable” price is one that bears a reasonable relationship to the prevailing market price of the security.<sup>[16]</sup> Dealers have a similar obligation with respect to the price of securities sold in agency transactions pursuant to Rule G-18. Dealer compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction, while compensation on an agency transaction generally consists of a commission. As part of the aggregate price to the customer, the mark-up or mark-down also must be fair and reasonable, taking into account all relevant factors.<sup>[17]</sup> Similarly, under Rule G-30(b), the commission on an agency transaction must be fair and reasonable, taking into account all relevant factors.

As a general matter, in addition to information about prices of transactions effected by such dealers and other market participants in such security, material information about a security available through EMMA or other established industry sources may also be among the relevant factors that the dealer should consider in connection with ensuring fair pricing of its transactions with investors. Among other things, dealers would be expected to have reviewed any applicable continuing disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account in determining a fair and reasonable transaction price. In addition, dealers should consider the effect of ratings on the value of the securities involved in customer transactions, and should specifically consider the effect of information from rating agencies, both with respect to actual or potential changes in the underlying rating of a security and with respect to actual or potential changes in the rating of any third-party credit enhancement applicable to the security.

Finally, many issuers currently include a retail order period in the marketing of new issues. The retail order period is intended to provide an opportunity for individual investors to place orders in advance of institutional investors. Dealers are reminded that an issuer’s use of a retail order period based on a perception that the retail order period will improve pricing of the new issue for the issuer does not create a safe harbor for dealers to engage in pricing that violates the fair pricing obligation under Rule G-30. Large differences between institutional and individual prices that exceed the price/yield variance that normally applies to transactions of different sizes in the primary market provide evidence that the duty of fair pricing to individual clients may not have been met.

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[1] See *Federal Reserve Flow of Funds*, Table L-211 (June 11, 2009) available at <http://www.federalreserve.gov/releases/z1/Current/> (The household category in the Table reflects direct investments by individual investors, as well as investments by trusts, investment advisors, arbitrageurs, and various other accounts that do not fall into other tracked categories).

[2] See *Reminder of Customer Protection Obligations in Connection With Sales of Municipal Securities*, MSRB Notice 2007-17 (May 30, 2007) (the “Fair Practice Notice”); *Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans*, MSRB Notice 2006-23 (August 7, 2006) (the “529 Notice”).

[3] See *Application of MSRB Rules to Transactions in Auction Rate Securities*, MSRB Notice 2008-09 (February 19, 2008) (the “ARS Notice”); *Bond Insurance Ratings Application of MSRB Rules*, MSRB Notice 2008-04 (January 22, 2008) (the “Bond Insurance Notice”).

[4] See Rule G-17 Interpretation – Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, March 20, 2002, *reprinted in* MSRB Rule Book (the “2002 Disclosure Notice”). The 2002 Disclosure Notice described these established industry sources as including such sources as the system of nationally recognized municipal securities information repositories (“NRMSIRs”) established by the SEC under Exchange Act Rule 15c2-12 for continuing disclosures by issuers and other obligors, the MSRB’s Municipal Securities Information Library® (MSIL®) system for official statements and advance refunding documents, the MSRB’s Transaction Reporting System for prices of transactions in municipal securities, rating agency reports, and other sources of information on municipal securities generally used by dealers that effect transactions in the type of securities at issue.

[5] See 2002 Disclosure Notice, *supra* n.4.

[6] Additional MSRB disclosure requirements under Rule G-15, relating to trade confirmations, and Rule G-32,

relating to official statements, focus on information to be provided after the investment decision and do not fulfill the Rule G-17 disclosure obligation because they are not provided at or prior to the investment decision. Recent amendments to MSRB Rule G-32 in connection with electronic dissemination of official statements to investors purchasing municipal securities in a primary offering do not alter this time-of-trade disclosure obligation.

[7] A dealer's specific investor protection obligations, including its disclosure, fair practice and suitability obligations under Rules G-17 and G-19, may be affected by the status of an institutional investor as a Sophisticated Municipal Market Professional ("SMMP"). See Rule G-17 Interpretation – Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals, April 30, 2002, *reprinted in* MSRB Rule Book. **[This notice was revised effective July 9, 2012.]**

[8] See ARS Notice and Bond Insurance Notice; see also *Basic v. Levinson*, 485 U.S. 224 (1988). The SEC has described material facts as those "facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision." *Municipal Securities Disclosure*, Exchange Act Release No. 26100 (September 22, 1988) at note 76, quoting *In re Walston & Co. Inc., and Harrington*, Exchange Act Release No. 8165 (September 22, 1967).

[9] See, e.g., [Rule G-17 Interpretation – Educational Notice on Bonds Subject to "Detachable" Call Features, May 13, 1993](#), *reprinted in* MSRB Rule Book; Rule G-17 Interpretation – Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, March 4, 1986, *reprinted in* MSRB Rule Book.

[10] See Bond Insurance Notice, *supra* n.3.

[11] The termination of the SBPA may result in other changes to the terms of securities, such as the loss of any rights to tender the securities for purchase or an interest rate to be determined based on a floating rate index or in another manner, which may produce a yield that is substantially below market for a fixed rate bond of comparable maturity. Such facts may be material to investors.

[12] See, e.g., Fair Practice Notice, *supra* n.2. The MSRB has previously stated that most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer, but determining whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. See Rule G-19 Interpretive Letter – Recommendations, February 17, 1998, published in *MSRB Rule Book*. The MSRB also has provided guidance on recommendations in the context of on-line communications in Rule G-19 Interpretation – Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transactions, to Online Communications, September 25, 2002, published in *MSRB Rule Book*.

[13] Rule G-8(a)(xi)(F) requires that dealers maintain records for each customer of such information about the customer used in making recommendations to the customer.

[14] See 529 Notice n.2; Fair Practice Notice n.2; Bond Insurance Notice n. 3.

[15] From time to time, the MSRB provides guidance on specific new products introduced into the municipal securities market. For example, the American Recovery and Reinvestment Act of 2009 authorized state and local governments to issue two types of Build America Bonds ("BABs") as taxable governmental bonds with federal subsidies for a portion of their borrowing costs. The MSRB has previously provided guidance to dealers regarding the application of MSRB rules to BABs, including fair practice rules. See [Build America Bonds and Other Tax Credit Bonds, MSRB Notice 2009-15 \(April 24, 2009\)](#); [Build America Bonds: Application of Rule G-37 to Solicitations of Issuers, MSRB Notice 2009-30 \(June 9, 2009\)](#). In addition, the MSRB has provided guidance on dealer transactions in registered warrants, or IOUs, issued by the State of California. See [Applicability of MSRB Rules to California Registered Warrants, MSRB Notice 2009-41 \(July 10, 2009\)](#). Nonetheless, dealers must understand the material features of any security they recommend, regardless of whether specific guidance is provided by the MSRB.

[16] See [Review of Dealer Pricing Responsibilities, MSRB Notice 2004-3 \(January 26, 2004\)](#) (the "Dealer Pricing Notice").

[17] Dealer Pricing Notice, *supra*.

## **NOTICE ON BANK TYING ARRANGEMENTS, UNDERPRICING OF CREDIT AND RULE G-17 ON FAIR DEALING - August 14, 2008**

The Municipal Securities Rulemaking Board is concerned that the recent increase in demand for liquidity facilities in the municipal securities market due to the downgrade of the monoline insurers and the conversion of auction rate securities programs may result in certain activities that could violate federal bank tying and underpricing of credit prohibitions. The MSRB wishes to remind dealers of these prohibitions as well as the fact that any broker, dealer or municipal securities dealer (dealer) that aids and abets a violation of federal bank tying or underpricing of credit prohibitions also would violate Rule G-17 on fair dealing.

Section 106 of the Bank Holding Company Act Amendments of 1970 prohibits commercial banks from imposing certain types of tying arrangements on their customers, a practice known as “tying.” Tying includes conditioning the availability or terms of loans or other credit products on the purchase of certain other products and services. It is legal for banks to tie credit and traditional banking products, such as cash management, but it is not legal for banks to tie credit and debt underwriting from the bank or from the bank’s investment affiliate. For example, a bank would violate Section 106 if the bank informs a customer seeking a liquidity facility from the bank that the bank will provide the liquidity facility only if the customer commits to hire the bank’s securities affiliate to underwrite an upcoming bond offering for the customer. Section 106, however, does not prohibit a customer from deciding on its own to award some of its business to a bank or an affiliate as a reward for the bank previously providing credit or other business to the customer. So too, if a bank provides a reduced rate on a liquidity facility because of an illegal tie in with an underwriting, that may also constitute an underpricing of credit (*i.e.*, an extension of credit below market rates). The underpricing could violate Section 23B of the Federal Reserve Act of 1913 which generally requires that certain transactions between a bank and its affiliates occur on market terms and applies to any transaction by a bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction. The MSRB encourages all interested parties to provide information concerning any arrangement in which the provision of liquidity facilities may have been illegally tied to investment banking services. Such information may be provided to the appropriate bank regulatory authority or, if provided to the MSRB, the MSRB will forward it to the appropriate bank regulatory authority. In addition, the MSRB cautions that any dealer that aids or abets a violation of bank tying or the underpricing of credit prohibitions also would violate Rule G-17. A dealer would be deemed to have aided and abetted a violation of the bank tying prohibition or underpricing of credit if it knew or had reason to know that the purchase of investment banking services had been tied to the provision and/or pricing of a liquidity facility by an affiliated bank in violation of the federal banking laws.

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## **BOND INSURANCE RATINGS – APPLICATION OF MSRB RULES - January 22, 2008**

Bond insurance companies recently have been subject to increased attention in the municipal securities market as a result of credit rating agency downgrades and ongoing credit agency reviews. Because of these recent events and the prominence of bond insurance in the municipal securities market, the MSRB is publishing this notice to review some of the investor protection rules applicable to brokers, dealers and municipal securities dealers (“dealers”) effecting transactions in insured municipal securities.

## **RULE G-17 AND TIME OF TRADE DISCLOSURE TO CUSTOMERS**

One of the most important MSRB investor protection rules is Rule G-17, which requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. A long-standing interpretation of Rule G-17 is that a dealer transacting with a customer [1] must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security.[2] Disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered “material” if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.[3] As applied to customer transactions in insured municipal securities, the disclosures required under Rule G-17 include a description of the securities and identification of any bond insurance as well as material facts that relate to the credit rating of the issue. The disclosures required under Rule G-17 also may include material facts about the credit enhancement applicable to the issue.

## March 2002 Notice

In a March 2002 Interpretative Notice, the MSRB provided specific guidance on the disclosure requirements of Rule G-17.<sup>[4]</sup> The March 2002 Notice clarified that, in addition to the requirement to disclose material facts about a transaction of which the dealer is specifically aware, the dealer is responsible for disclosing any material fact that has been made available through sources such as the NRMSIR system,<sup>[5]</sup> the Municipal Securities Information Library® (MSIL®) system,<sup>[6]</sup> RTRS,<sup>[7]</sup> *rating agency reports* and other sources of information relating to the municipal securities transaction generally used by dealers that effect transactions in the type of municipal securities at issue (collectively, “established industry sources”).<sup>[8]</sup> The inclusion of “rating agency reports” within the list of “established industry sources” of information makes clear the Board’s view that information about the rating of a bond, or information from the rating agency about potential rating actions with respect to a bond, may be material information about the transaction. It follows that, where the issue’s credit rating is based in whole or in part on bond insurance, the credit rating of the insurance company, or information from the rating agency about potential rating actions with respect to the bond insurance company, may be material information about the transaction.

In addition to the actual credit rating of a municipal issue, “underlying” credit ratings are assigned by rating agencies to some municipal securities issues. An underlying credit rating is assigned to reflect the credit quality of an issue independent of credit enhancements such as bond insurance. The underlying rating (or the lack of an underlying rating)<sup>[9]</sup> may be relevant to a transaction when the credit rating of the bond insurer is downgraded or is the subject of information from the rating agency about a potential rating action with respect to the insurance company. In order to ensure all required disclosures are made under Rule G-17, a dealer must take into consideration information on underlying credit ratings that is available in established industry sources (or information otherwise known to the dealer) and must incorporate such information when determining the material facts to be disclosed about the transaction.

## April 2002 Notice on Sophisticated Municipal Market Professionals

In a notice dated April 30, 2002, the MSRB provided additional guidance on Rule G-17 and other customer protection rules as they apply to transactions with a special class of institutional customers known as “Sophisticated Municipal Market Professionals” (“SMMPs”).<sup>[10]</sup> The April 2002 Notice provides a definition of SMMP, which includes critical elements such as the customer’s financial sophistication and access to established industry sources for municipal securities information. When a dealer has reasonable grounds for concluding that the institutional customer is an SMMP as defined in the April 2002 Notice, the institutional customer necessarily is already aware, or capable of making itself aware of, material facts found in the established industry sources. In addition, the customer in such cases is able to independently understand the significance of such material facts.

The April 2002 Notice provides that a dealer’s Rule G-17 obligation to affirmatively disclose material facts available from established industry sources is qualified to some extent in certain kinds of SMMP transactions. Specifically, when effecting nonrecommended, secondary market transactions, a dealer is not required to provide an SMMP with affirmative disclosure of the material facts that already exist in established industry sources. This differs from the general Rule G-17 requirement of disclosure, discussed above, and therefore may be relevant to dealers trading with SMMPs in insured municipal securities.

## RULE G-19 AND SUITABILITY DETERMINATIONS

In addition to the customer disclosure obligations relating to bond insurance and credit ratings, dealers also should be aware of how suitability requirements of MSRB Rule G-19 relate to transactions in insured bonds that are recommended to customers. Rule G-19 provides that a dealer must consider the nature of the security as well as the customer’s financial status, tax status and investment objectives when making recommendations to customers. The dealer must have reasonable grounds for believing that the recommendation is suitable, based upon information available about the security and the facts disclosed by or otherwise known about the customer.<sup>[11]</sup> Facts relating to the credit rating of a bond insurer may affect suitability determinations, particularly for customers that have conveyed to the dealer investment objectives relating to credit quality of investments. For example, if a customer has expressed the desire to purchase only “triple A” rated securities, recommendations to the customer should take into account information from rating agencies, including information about potential rating actions that may affect the future “triple A” status of the issue.<sup>[12]</sup>

## RULE G-30 AND FAIR PRICING REQUIREMENTS

Another important investor protection provision within MSRB rules is Rule G-30 on prices and commissions. Rule G-30 requires that, for principal transactions with customers, the dealer must ensure that the price of each transaction is fair and reasonable, taking into account all relevant factors. Dealers should consider the effect of ratings on the value of the securities involved in customer transactions, and should specifically consider the effect of information from rating agencies, both with respect to actual or potential changes in the underlying rating of a security and with respect to actual or potential changes in the rating of any bond insurance applicable to the security.

## RULE G-15(a) AND CONFIRMATION DISCLOSURE

The content of information required to be included on customer confirmations of municipal securities transactions is set forth in MSRB Rule G-15(a). For securities with additional credit backing, such as bond insurance, the rule requires the confirmation to state “the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to debt service.”<sup>[13]</sup> Rule G-15(a) does not generally require that credit agency ratings be included on customer confirmations. However, if credit ratings are given on the confirmation, the ratings must be correct.

## CONCLUSION

Meeting the disclosure requirements of Rule G-17 requires attention to the facts and circumstances of individual transactions as well as attention to the specific securities and customers that are involved in those transactions. In light of recent events affecting credit ratings of bond insurance companies, dealers may wish to review both the March 2002 Notice on Rule G-17 disclosure requirements and the April 2002 Notice on SMMP transactions to ensure compliance with the rule in the changing environment for bond insurance companies. In addition, dealers may wish to review how transactions in insured securities are being recommended, priced and confirmed to customers to ensure compliance with other MSRB investor protection rules.

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<sup>[1]</sup> The word “customer,” as used in this notice, follows the definition in [MSRB Rule D-9](#), which states that a “customer” is any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities.

<sup>[2]</sup> See, e.g., *Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (March 4, 1986)*, MSRB Manual (CCH) para. 3591.

<sup>[3]</sup> See, e.g., *Basic v. Levinson*, 485 U.S. 224 (1988).

<sup>[4]</sup> Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, MSRB Notice (March 20, 2002) (hereinafter “March 2002 Notice”).

<sup>[5]</sup> For purposes of this notice, the “NRMSIR system” refers to the disclosure dissemination system adopted by the SEC in SEC Rule 15c2-12.

<sup>[6]</sup> The MSIL<sup>®</sup> system collects and makes available to the marketplace official statements and advance refunding documents submitted under MSRB Rule G-36, on the delivery of official statements, as well as certain secondary market material event disclosures provided by issuers under SEC Rule 15c2-12. Municipal Securities Information Library<sup>®</sup> and MSIL<sup>®</sup> are registered trademarks of the MSRB.

<sup>[7]</sup> The MSRB’s Real-Time Transaction Reporting System (“RTRS”) collects and makes available to the marketplace information regarding inter-dealer and dealer-customer transactions in municipal securities.

<sup>[8]</sup> See *March 2002 Notice* (emphasis added).

<sup>[9]</sup> The lack of a rating for a municipal issue does not necessarily imply that the credit quality of such an issue is inferior, but is information that should be taken into account when accessing material facts about a transaction in the security.

<sup>[10]</sup> Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market

Professionals (April 30, 2002) (hereinafter "April 2002 Notice"). **[This notice was revised effective July 9, 2012.]**

[11] As with [Rule G-17](#), the MSRB has provided specific qualifications with respect to how a dealer fulfills its suitability duties when making recommendations to SMMPs. These are described in the April 2002 Notice on SMMPs, discussed above.

[12] To assure that a dealer effecting a recommended transaction with a non-SMMP customer has the information needed about the customer to make its suitability determination, [Rule G-19](#) requires the dealer to make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation. The obligations arising under Rule G-19 in connection with a recommended transaction require a meaningful analysis, taking into consideration the information obtained about the customer and the security, which establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, which factors may vary from transaction to transaction. See [Reminder of Customer Protection Obligations In Connection With Sales of Municipal Securities, MSRB Notice 2007-17 \(May 30, 2007\)](#).

[13] The rule provides that, if there is more than one such obligor, the statement "multiple obligors" may be shown. If a security is unrated by a nationally recognized statistical rating organization, [Rule G-15\(a\)](#) requires dealers to disclose the fact that the security is unrated.

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## **REMINDER OF CUSTOMER PROTECTION OBLIGATIONS IN CONNECTION WITH SALES OF MUNICIPAL SECURITIES - March 30, 2007**

The Municipal Securities Rulemaking Board ("MSRB") is publishing this notice to remind brokers, dealers and municipal securities dealers ("dealers") of their customer protection obligations—specifically the application of Rule G-17, on fair dealing, and Rule G-19, on suitability—in connection with their municipal securities sales activities, including but not limited to situations in which dealers offer sales incentives.[1]

### **Basic Customer Protection Obligation**

At the core of the MSRB's customer protection rules is Rule G-17 which provides that, in the conduct of its municipal securities activities, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. The rule encompasses two basic principles: an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, and a general duty to deal fairly even in the absence of fraud. All activities of dealers must be viewed in light of these basic principles, regardless of whether other MSRB rules establish specific requirements applicable to such activities.

### **Disclosure**

The MSRB has interpreted Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale of the securities to the customer, all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.[2] This duty applies to any transaction in a municipal security regardless of whether the dealer has recommended the transaction. Dealers should make certain that information they provide to their customers, whether provided under an affirmative disclosure obligation imposed by MSRB rules or in response to questions from customers, is correct and not misleading. Further, dealers are reminded that disclosures made to customers as required under MSRB rules do not relieve dealers of their suitability obligations—including the obligation to consider the customer's financial status, tax status and investment objectives—if they have recommended transactions in municipal securities.

### **Suitability**

Under Rule G-19, a dealer that recommends to a customer a transaction in a municipal security must have reasonable grounds for believing that the recommendation is suitable, based upon information available from the issuer of the security or otherwise and the facts disclosed by or otherwise known about the customer.[3] To assure

that a dealer effecting a recommended transaction with a non-institutional customer has the information needed about the customer to make its suitability determination, Rule G-19 requires the dealer to make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation.<sup>[4]</sup> Dealers are reminded that the obligation arising under Rule G-19 in connection with a recommended transaction requires a meaningful analysis, taking into consideration the information obtained about the customer and the security, which establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, which factors may vary from transaction to transaction. Pursuant to Rule G-27, on supervision, dealers must have written supervisory procedures in place that are reasonably designed to ensure compliance with the Rule G-19 obligation to undertake a suitability analysis in connection with every recommended transaction, and dealers must enforce these procedures to ensure that such meaningful analysis does in fact occur in connection with the dealer's recommended transactions.

### **Other Sales Practice Principles**

Dealers must keep in mind the requirements under Rule G-17—that they deal fairly with all persons and that they not engage in any deceptive, dishonest or unfair practice—when considering the appropriateness of day-to-day sales-related activities with respect to municipal securities. In some cases, certain sales-related activities are governed in part by specific MSRB rules, such as Rule G-19 (as described above), Rule G-18 on execution of transactions, and Rule G-30 on prices and commissions. Other activities may not be explicitly addressed by a specific MSRB rule. In either case, the general principles of Rule G-17 always apply.

In particular, dealers must ensure that they do not engage in transactions that are unfair to customers under Rule G-17. This principle applies in the case of an individual transaction to ensure that the dealer does not unfairly attempt to increase its own revenue or otherwise advance its interests without due regard to the customer's interests. In addition, where a dealer consistently recommends that customers invest in the municipal securities that offer the dealer the highest compensation, such pattern or general practice may, depending on the facts and circumstances, constitute a violation of Rule G-17 if the recommendation of such municipal securities over the other municipal securities offered by the dealer does not reflect a legitimate investment-based purpose.

With respect to sales incentives, the MSRB has previously interpreted Rule G-20, relating to gifts, gratuities and non-cash compensation, to require a dealer that sponsors a sales contest involving representatives who are not employed by the sponsoring dealer to have in place written agreements with these representatives.<sup>[5]</sup> Dealers are also reminded that Rule G-20(d) establishes standards regarding non-cash incentives for sales of municipal securities that are substantially similar to those currently applicable to the public offering of corporate securities under NASD Rule 2710(j) but also include "total production" and "equal weighting" requirements for internal sales contests. Dealers should be mindful that financial incentives may cause an associated person (whether an associated person of the dealer offering the sales incentive or an associated person of another dealer) to favor one municipal security over another and thereby potentially compromise the dealer's obligations under MSRB rules, including Rules G-17 and G-19. Rule G-17 may be violated if a dealer or any of its associated persons engages in any marketing activities that result in a customer being treated unfairly, or if the dealer or any of its associated persons engages in any deceptive, dishonest or unfair practice in connection with such marketing activities. The MSRB also believes that, depending upon the specific facts and circumstances, a dealer may violate Rule G-17 if it acts in a manner that is reasonably likely to induce another dealer or such other dealer's associated persons to violate the principles of Rule G-17 or other MSRB customer protection rules, such as Rule G-18, G-19 or Rule G-30.

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<sup>[1]</sup> The principles enunciated in this notice were previously discussed, in the context of the 529 college savings plan market, in [Rule G-17 Interpretation - Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans \(August 7, 2006\)](#), reprinted in *MSRB Rule Book*. This notice makes clear that the general principles discussed in the August 2006 interpretation also apply in the context of the markets for municipal bonds, notes and other types of municipal securities. This notice in no way alters the substance or applicability of the August 2006 interpretation with respect to the 529 college savings plan market.

[2] See [Rule G-17 Interpretation - Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts \(March 20, 2002\)](#), reprinted in *MSRB Rule Book*.

[3] The MSRB has previously stated that most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer, but determining whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. See , February 17, 1998 [Rule G-19 Interpretive Letter - Recommendations](#), reprinted in *MSRB Rule Book*. The MSRB also has provided guidance on recommendations in the context of on-line communications in , September 25, 2002 [Rule G-19 Interpretation - Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transaction, to Online Communications](#), reprinted in *MSRB Rule Book*.

[4] Rule G-8(a)(x)(F) requires that dealers maintain records for each customer of such information about the customer used in making recommendations to the customer. Rule G-19(e), on churning, also prohibits a dealer from recommending transactions to a customer that are excessive in size or frequency, in view of information known to such dealer concerning the customer's financial background, tax status and investment objectives.

[5] See [Rule G-20 Interpretive Letter - Authorization of sales contests, June 25, 1982](#), reprinted in *MSRB Rule Book*.

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## **INTERPRETATION ON CUSTOMER PROTECTION OBLIGATIONS RELATING TO THE MARKETING OF 529 COLLEGE SAVINGS PLANS - August 7, 2006**

The Municipal Securities Rulemaking Board ("MSRB") is publishing this interpretation to ensure that brokers, dealers and municipal securities dealers ("dealers") effecting transactions in the 529 college savings plan market fully understand their fair practice and disclosure duties to their customers.<sup>[1]</sup>

### **Basic Customer Protection Obligation**

At the core of the MSRB's customer protection rules is Rule G-17, which provides that, in the conduct of its municipal securities activities, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. The rule encompasses two basic principles: an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 (the "Exchange Act"), and a general duty to deal fairly even in the absence of fraud. All activities of dealers must be viewed in light of these basic principles, regardless of whether other MSRB rules establish specific requirements applicable to such activities.

### **Disclosure**

The MSRB has interpreted Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale of the securities to the customer (the "time of trade"), all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.<sup>[2]</sup> This duty applies to any dealer transaction in a 529 college savings plan interest regardless of whether the transaction has been recommended by the dealer.

Many states offer favorable state tax treatment or other valuable benefits to their residents in connection with investments in their own 529 college savings plan. In the case of sales of out-of-state 529 college savings plan interests to a customer, the MSRB views Rule G-17 as requiring a dealer to make, at or prior to the time of trade, additional disclosures that:

- (i) depending upon the laws of the home state of the customer or designated beneficiary, favorable state tax treatment or other benefits offered by such home state for investing in 529 college savings plans may be available only if the customer invests in the home state's 529 college savings plan;
- (ii) any state-based benefit offered with respect to a particular 529 college savings plan should be one of many appropriately weighted factors to be considered in making an

investment decision; and

(iii) the customer should consult with his or her financial, tax or other adviser to learn more about how state-based benefits (including any limitations) would apply to the customer's specific circumstances and also may wish to contact his or her home state or any other 529 college savings plan to learn more about the features, benefits and limitations of that state's 529 college savings plan.

This disclosure obligation is hereinafter referred to as the "out-of-state disclosure obligation."<sup>[3]</sup>

The out-of-state disclosure obligation may be met if the disclosure appears in the program disclosure document, so long as the program disclosure document has been delivered to the customer at or prior to the time of trade and the disclosure appears in the program disclosure document in a manner that is reasonably likely to be noted by an investor.<sup>[4]</sup> A presentation of this disclosure in the program disclosure document in close proximity and with equal prominence to the principal presentation of substantive information regarding other federal or state tax-related consequences of investing in the 529 college savings plan, and the inclusion of a reference to this disclosure in close proximity and with equal prominence to each other presentation of information regarding state tax-related consequences of investing in the 529 college savings plan, would be deemed to satisfy this requirement.<sup>[5]</sup>

The MSRB has no authority to mandate inclusion of any particular items in the issuer's program disclosure document.<sup>[6]</sup> Dealers who wish to rely on the program disclosure document for fulfillment of the out-of-state disclosure obligation are responsible for understanding what is included within the program disclosure document of any 529 college savings plan they market and for determining whether such information is sufficient to meet this disclosure obligation. Notwithstanding any of the foregoing, disclosure through the program disclosure document as described above is not the sole manner in which a dealer may fulfill its out-of-state disclosure obligation. Thus, if the issuer has not included this information in the program disclosure document in the manner described, inclusion in the program disclosure document in another manner may nonetheless fulfill the dealer's out-of-state disclosure obligation so long as disclosure in such other manner is reasonably likely to be noted by an investor. Otherwise, the dealer would remain obligated to disclose such information separately to the customer under Rule G-17 by no later than the time of trade.<sup>[7]</sup>

If the dealer proceeds to provide information to an out-of-state customer about the state tax or other benefits available through such customer's home state, Rule G-17 requires that the dealer ensure that the information is not false or misleading. For example, a dealer would violate Rule G-17 if it were to inform a customer that investment in the 529 college savings plan of the customer's home state did not provide the customer with any state tax benefit even though such a state tax benefit is in fact available. Furthermore, a dealer would violate Rule G-17 if it were to inform a customer that investment in the 529 college savings plan of another state would provide the customer with the same state tax benefits as would be available if the customer were to invest in his or her home state's 529 college savings plan even though this is not the case.<sup>[8]</sup> Dealers should make certain that information they provide to their customers, whether provided under an affirmative disclosure obligation imposed by MSRB rules or in response to questions from customers, is correct and not misleading.

Dealers are reminded that this out-of-state disclosure obligation is in addition to their general obligation under Rule G-17 to disclose to their customers at or prior to the time of trade all material facts known by dealers about the 529 college savings plan interests they are selling to their customers, as well as material facts about such 529 college savings plan that are reasonably accessible to the market. Further, dealers are reminded that disclosures made to customers as required under MSRB rules with respect to 529 college savings plans do not relieve dealers of their suitability obligations—including the obligation to consider the customer's financial status, tax status and investment objectives—if they have recommended investments in 529 college savings plans.

### **Suitability**

Under Rule G-19, a dealer that recommends to a customer a transaction in a security must have reasonable grounds

for believing that the recommendation is suitable, based upon information available from the issuer of the security or otherwise and the facts disclosed by or otherwise known about the customer.<sup>[9]</sup> To assure that a dealer effecting a recommended transaction with a non-institutional customer has the information needed about the customer to make its suitability determination, the rule requires the dealer to make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation.<sup>[10]</sup> Dealers are reminded that the obligation arising under Rule G-19 in connection with a recommended transaction requires a meaningful analysis, taking into consideration the information obtained about the customer and the security, that establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, which factors may vary from transaction to transaction.<sup>[11]</sup> Pursuant to Rule G-27(c), dealers must have written supervisory procedures in place that are reasonably designed to ensure compliance with this Rule G-19 obligation to undertake a suitability analysis in connection with every recommended transaction, and dealers must enforce these procedures to ensure that such meaningful analysis does in fact occur in connection with the dealer's recommended transactions.

In the context of a recommended transaction relating to a 529 college savings plan, the MSRB believes that it is crucial for dealers to remain cognizant of the fact that these instruments are designed for a particular purpose and that this purpose generally should match the customer's investment objective. For example, dealers should bear in mind the potential tax consequences of a customer making an investment in a 529 college savings plan where the dealer understands that the customer's investment objective may not involve use of such funds for qualified higher education expenses.<sup>[12]</sup> Dealers also should consider whether a recommendation is consistent with the customer's tax status and any customer investment objectives materially related to federal or state tax consequences of an investment.

Furthermore, investors generally are required to designate a specific beneficiary under a 529 college savings plan. The MSRB believes that information known about the designated beneficiary generally would be relevant in weighing the investment objectives of the customer, including (among other things) information regarding the age of the beneficiary and the number of years until funds will be needed to pay qualified higher education expenses of the beneficiary. The MSRB notes that, since the person making the investment in a 529 college savings plan retains significant control over the investment (e.g., may withdraw funds, change plans, or change beneficiary, etc.), this person is appropriately considered the customer for purposes of Rule G-19 and other MSRB rules. As noted above, information regarding the designated beneficiary should be treated as information relating to the customer's investment objective for purposes of Rule G-19.

In many cases, dealers may offer the same investment option in a 529 college savings plan sold with different commission structures. For example, an A share may have a front-end load, a B share may have a contingent deferred sales charge or back-end load that reduces in amount depending upon the number of years that the investment is held, and a C share may have an annual asset-based charge. A customer's investment objective—particularly, the number of years until withdrawals are expected to be made—can be a significant factor in determining which share class would be suitable for the particular customer.

Rule G-19(e), on churning, prohibits a dealer from recommending transactions to a customer that are excessive in size or frequency, in view of information known to such dealer concerning the customer's financial background, tax status and investment objectives. Thus, for example, where the dealer knows that a customer is investing in a 529 college savings plan with the intention of receiving the available federal tax benefit, such dealer could, depending upon the facts and circumstances, violate rule G-19(e) if it were to recommend roll-overs from one 529 college savings plan to another with such frequency as to lose the federal tax benefit. Even where the frequency does not imperil the federal tax benefit, roll-overs recommended year after year by a dealer could, depending upon the facts and circumstances (including consideration of legitimate investment and other purposes), be viewed as churning. Similarly, depending upon the facts and circumstances, where a dealer recommends investments in one or more plans for a single beneficiary in amounts that far exceed the amount that could reasonably be used by such beneficiary to pay for qualified higher education expenses, a violation of rule G-19(e) could result.<sup>[13]</sup>

## **Other Sales Practice Principles**

Dealers must keep in mind the requirements under Rule G-17—that they deal fairly with all persons and that they not engage in any deceptive, dishonest or unfair practice—when considering the appropriateness of day-to-day sales-related activities with respect to municipal fund securities, including 529 college savings plans. In some cases, certain sales-related activities are governed in part by specific MSRB rules, such as Rule G-19 (as described above) and Rule G-30(b), on commissions.<sup>[14]</sup> Other activities may not be explicitly addressed by a specific MSRB rule. In either case, the general principles of Rule G-17 always apply.

In particular, dealers must ensure that they do not engage in transactions primarily designed to increase commission revenues in a manner that is unfair to customers under Rule G-17. Thus, in addition to being a potential violation of Rule G-19 as discussed above, recommending a particular share class to a customer that is not suitable for that customer, or engaging in churning, may also constitute a violation of Rule G-17 if the recommendation was made for the purpose of generating higher commission revenues. Also, where a dealer offers investments in multiple 529 college savings plans, consistently recommending that customers invest in the one 529 college savings plan that offers the dealer the highest compensation may, depending on the facts and circumstances, constitute a violation of Rule G-17 if the recommendation of such 529 college savings plan over the other 529 college savings plans offered by the dealer does not reflect a legitimate investment-based purpose.

Further, recommending transactions to customers in amounts designed to avoid commission discounts (*i.e.*, sales below breakpoints where the customer would be entitled to lower commission charges) may also violate Rule G-17, depending upon the facts and circumstances. For example, a recommendation that a customer make two smaller investments in separate but nearly identical 529 college savings plans for the purposes of avoiding a reduced commission rate that would be available upon investing the full amount in a single 529 college savings plan, or that a customer time his or her multiple investments in a 529 college savings plan so as to avoid being able to take advantage of a lower commission rate, in either case without a legitimate investment-based purpose, could violate Rule G-17.

With respect to sales incentives, the MSRB has previously interpreted Rule G-20, relating to gifts, gratuities and non-cash compensation, to require a dealer that sponsors a sales contest involving representatives who are not employed by the sponsoring dealer to have in place written agreements with these representatives.<sup>[15]</sup> In addition, the general principles of Rule G-17 are applicable. Thus, if a dealer or any of its associated persons engages in any marketing activities that result in a customer being treated unfairly, or if the dealer or any of its associated persons engages in any deceptive, dishonest or unfair practice in connection with such marketing activities, Rule G-17 could be violated. The MSRB believes that, depending upon the specific facts and circumstances, a dealer may violate Rule G-17 if it acts in a manner that is reasonably likely to induce another dealer or such other dealer's associated persons to violate the principles of Rule G-17 or other MSRB customer protection rules, such as Rule G-19 or Rule G-30. Dealers are also reminded that Rule G-20 establishes standards regarding incentives for sales of municipal securities, including 529 college savings plan interests, that are substantially similar to those currently applicable to sales of mutual fund shares under NASD rules.

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<sup>[1]</sup> 529 college savings plans are established by states under Section 529(b)(A)(ii) of the Internal Revenue Code as “qualified tuition programs” through which individuals make investments for the purpose of accumulating savings for qualifying higher education costs of beneficiaries. Section 529 of the Internal Revenue Code also permits the establishment of so-called prepaid tuition plans by states and higher education institutions, which are not treated as 529 college savings plans for purposes of this notice.

<sup>[2]</sup> See Rule G-17 Interpretation – Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, March 20, 2002, *reprinted in* MSRB Rule Book.

<sup>[3]</sup> This out-of-state disclosure obligation constitutes an expansion of, and supersedes, certain disclosure requirements with respect to out-of-state 529 college savings plan transactions established under “Application of Fair Practice and Advertising Rules to Municipal Securities,” May 14, 2002, published in *MSRB Rule Book*.

<sup>[4]</sup> As used in this notice, the term “program disclosure document” has the same meaning as “official statement”

under the rules of the MSRB and SEC. The delivery of the program disclosure document to customers pursuant to [Rule G-32](#), which requires delivery by settlement of the transaction, would be timely for purposes of [Rule G-17](#) only if such delivery is accelerated so that it is received by the customer by no later than the time of trade.

[5] Thus, if the program disclosure document contains a series of sections in which the principal disclosures of substantive information on federal or state-tax related consequences of investing in the 529 college savings plan appear, a single inclusion of the required disclosure within, at the beginning or at the end of such series would be satisfactory for purposes of the inclusion with the principal presentation of such other disclosures. Similarly, if the program disclosure document includes any other series of statements on state-tax related consequences, such as might exist in a summary statement appearing at the beginning of some program disclosure documents, a single prominent reference in the summary statement to the fuller disclosure made pursuant to the out-of-state disclosure obligation appearing elsewhere in the program disclosure document would be satisfactory.

[6] However, the MSRB notes that Exchange Act Rule 15c2-12(f)(3) of the SEC defines a “final official statement” as:

a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section.

Section (b) of that rule requires that the participating underwriter of an offering review a “deemed-final” official statement and contract to receive the final official statement from the issuer. See [Rule D-12 Interpretation – Interpretation Relating to Sales of Municipal Fund Securities in the Primary Market, January 18, 2001](#), published in *MSRB Rule Book*, for a discussion of the applicability of Rule 15c2-12 to offerings of 529 college savings plans.

[7] Although [Rule G-17](#) does not dictate the precise manner in which material facts must be disclosed to the customer at or prior to the time of trade, dealers must ensure that such disclosure is effectively provided to the customer in connection with the specific transaction and cannot merely rely on the inclusion of a disclosure in general advertising materials.

[8] Dealers should note that these examples are illustrative and do not limit the circumstances under which, depending on the facts and circumstances, a [Rule G-17](#) violation could occur.

[9] The MSRB has previously stated that most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer, but determining whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. See [Rule G-19 Interpretive Letter – Recommendations, February 17, 1998](#), published in *MSRB Rule Book*. The MSRB also has provided guidance on recommendations in the context of on-line communications in [Rule G-19 Interpretation – Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transactions, to Online Communications, September 25, 2002](#), published in *MSRB Rule Book*.

[10] Rule G-8(a)(xi)(F) requires that dealers maintain records for each customer of such information about the customer used in making recommendations to the customer.

[11] Although certain factors relating to recommended transactions in 529 college savings plans are discussed in this notice, whether such enumerated factors or any other considerations are relevant in connection with a particular recommendation is dependent upon the facts and circumstances. The factors that may be relevant with respect to a specific transaction in a 529 college savings plan generally include the various considerations that would be applicable in connection with the process of making suitability determinations for recommendations of any other type of security.

[12] See Section 529(c)(3) of the Internal Revenue Code. State tax laws also may result in certain adverse consequences for use of funds other than for educational costs.

[13] The MSRB understands that investors may change designated beneficiaries and therefore amounts in excess of what a single beneficiary could use ultimately might be fully expended by additional beneficiaries. The MSRB expresses no view as to the applicability of federal tax law to any particular plan of investment and does not interpret its rules to prohibit transactions in furtherance of legitimate tax planning objectives, so long as any recommended transaction is suitable.

[14] The MSRB has previously provided guidance on dealer commissions in [Rule G-30 Interpretation – Interpretive Notice on Commissions and Other Charges, Advertisements and Official Statements Relating to Municipal Fund Securities, December 19, 2001](#), published in *MSRB Rule Book*. The MSRB believes that Rule G-30(b), as interpreted in this 2001 guidance, should effectively maintain dealer charges for 529 college savings plan sales at a level consistent with, if not lower than, the sales loads and commissions charged for comparable mutual fund sales.

[15] See [Rule G-20 Interpretive Letter – Authorization of sales contests, June 25, 1982](#), published in *MSRB Rule Book*.

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## **INTERPRETIVE REMINDER NOTICE REGARDING RULE G-17, ON DISCLOSURE OF MATERIAL FACTS-- DISCLOSURE OF ORIGINAL ISSUE DISCOUNT BONDS - January 5, 2005**

The MSRB is publishing this notice to remind dealers of their affirmative disclosure obligations when effecting transactions with customers in original issue discount bonds. An original issue discount bond, or O.I.D. bond, is a bond that was sold at the time of issue at a price that included an original issue discount. The original issue discount is the amount by which the par value of the bond exceeded its public offering price at the time of its original issuance. The original issue discount is amortized over the life of the security and, on a municipal security, is generally treated as tax-exempt interest. When the investor sells the security before maturity, any profit realized on such sale is calculated (for tax purposes) on the adjusted book value, which is calculated for each year the security is outstanding by adding the accretion value to the original offering price. The amount of the accretion value (and the existence and total amount of original issue discount) is determined in accordance with the provisions of the Internal Revenue Code and the rules and regulations of the Internal Revenue Service.[1]

Rule G-17, the MSRB's fair dealing rule, encompasses two general principles. First, the rule imposes a duty on dealers not to engage in deceptive, dishonest, or unfair practices. This first prong of Rule G-17 is essentially an antifraud prohibition. In addition to the basic antifraud provisions in the rule, the rule imposes a duty to deal fairly with all persons. As part of a dealer's obligation to deal fairly, the MSRB has interpreted the rule to create affirmative disclosure obligations for dealers. The MSRB has stated that the dealer's affirmative disclosure obligations require that a dealer disclose, at or before the sale of municipal securities to a customer, all material facts concerning the transaction, including a complete description of the security.[2] These obligations apply even when a dealer is effecting non-recommended secondary market transactions.

In the context of the sale to customers of an original issue discount security, the MSRB's customer confirmation rule, Rule G-15(a), provides that information regarding the status of bonds as original issue discount securities must be included on customer confirmations. Specifically, Rule G-15(a)(i)(C)(4)(c) provides that, "If the securities pay periodic interest and are sold by the underwriter as original issue discount securities, a designation that they are "original issue discount" securities and a statement of the initial public offering price of the securities, expressed as a dollar price" must be included on the customer's confirmation.

The MSRB previously has alerted dealers of their obligation to make original issue discount disclosures to customers and has stated that, “The Board believes that the fact that a security bears an original issue discount is material information (since it may affect the tax treatment of the security); therefore, this fact should be disclosed to a customer prior to or at the time of trade.”<sup>[3]</sup> The MSRB is publishing this notice to remind dealers of their disclosure obligations under Rule G-17 because it remains concerned that, absent adequate disclosure of a security’s original issue discount status, an investor might not be aware that all or a portion of the component of his or her investment return represented by accretion of the discount is tax-exempt, and therefore might sell the securities at an inappropriately low price (*i.e.*, at a price not reflecting the tax-exempt portion of the discount) or pay capital gains tax on the accreted discount amount. Without appropriate disclosure, an investor also might not be aware of how his or her transaction price compares to the initial public offering price of the security. Appropriate disclosure of a security’s original issue discount feature should assist customers in computing the market discount or premium on their transaction.

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[1] See Glossary of Municipal Securities Terms, Second Edition (January 2004).

[2] See e.g., *Rule G-17 Interpretation—Educational Notice on Bonds Subject to “Detachable” Call Features*, May 13, 1993, *MSRB Rule Book* (July 2004) at 135.

[3] Rules G-12 and G-15, Comments Requested on Draft Amendments on Original Issue Discount Securities, *MSRB Reports*, Vol. 4, No. 6 (May 1994) at 7.

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#### **Purchase of new issue from issuer - December 1, 1997**

**Purchase of new issue from issuer.** This is in response to your letter in which you ask whether Board rule G-17, on fair dealing, or any other rule, regulation or federal law, requires an underwriter to purchase a bond issue from a municipal securities issuer at a “fair price.”

Rule G-17 states that, in the conduct of its municipal securities business, each broker, dealer and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. Thus, the rule requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities.

Whether or not an underwriter has dealt fairly with an issuer is dependent upon the facts and circumstances of an underwriting and cannot be addressed simply by virtue of the price of the issue. For example, in a competitive underwriting where an issuer reserves the right to reject all bids, a dealer submits a bid at a net interest cost it believes will enable it to successfully market the issue to investors. One could not view a dealer as having violated rule G-17 just because it did not submit a bid that the issuer considers fair. On the other hand, when a dealer is negotiating the underwriting of municipal securities, a dealer has an obligation to negotiate in good faith with the issuer. If the dealer represents to the issuer that it is providing the best market price available on this issue, and this is not the case, the dealer may violate rule G-17. Also, if the dealer knows the issuer is unsophisticated or otherwise depending on the dealer as its sole source of market information, the dealer’s duty under rule G-17 is to ensure that the issuer is treated fairly, specifically in light of the relationship of reliance that exists between the issuer and the underwriter. *MSRB interpretation of December 1, 1997.*

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#### **TRANSACTIONS IN MUNICIPAL SECURITIES WITH NON-STANDARD FEATURES AFFECTING PRICE/YIELD CALCULATIONS - June 12, 1995**

Rule G-15(a) generally requires that confirmations of municipal securities transactions with customers state a dollar price and yield for the transaction. Thus, for transactions executed on a dollar price basis, a yield must be calculated; for transactions executed on a yield basis, a dollar price must be calculated. Rule G-33 provides the standard formulae for making these price/yield calculations.

It has come to the Board’s attention that certain municipal securities have been issued in recent years with features

that do not fall within any of the standard formulae and assumptions in rule G-33, nor within the calculation formulae available through the available settings on existing bond calculators. For example, an issue may have first and last coupon periods that are longer than the standard coupon period of six months.

With respect to some municipal securities issues with non-standard features, industry members have agreed to certain conventions regarding price/yield calculations. For example, one of the available bond calculator setting might be used for the issue, even though the calculator setting does not provide a formula specifically designed to account for the non-standard feature. In such cases, anomalies may result in the price/yield calculations. The anomalies may appear when the calculations are compared to those using more sophisticated actuarial techniques or when the calculations are compared to those of other securities that are similar, but that do not have the non-standard feature.

The Board reminds dealers that, under rule G-17, dealers have the obligation to explain all material facts about a transaction to a customer buying or selling a municipal security. Dealers should take particular effort to ensure that customers are aware of any non-standard feature of a security. If price/yield calculations are affected by anomalies due to a non-standard feature, this may also constitute a material fact about the transaction that must be disclosed to the customer.

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## **EDUCATIONAL NOTICE ON BONDS SUBJECT TO "DETACHABLE" CALL FEATURES - May 13, 1993**

New products are constantly being introduced into the municipal securities market. Dealers must ensure that, prior to effecting transactions with customers in municipal securities with new features, they obtain all necessary information regarding these features. The Board will attempt periodically through educational notices to describe new products or features of municipal securities and review the responsibilities of dealers to customers in these transactions. In this notice, the Board will review detachable call features.

Certain recent issues of municipal securities include a new feature called a detachable call right. This feature allows the issuer to sell its right to call the bond. Thus, upon the sale of this call right, the owner of the right has the ability, at certain times, to require the mandatory tender of the underlying municipal bond. The dates of mandatory tender of the underlying bonds generally correlate with the optional call dates. If the holder exercises such rights, the underlying bondholder tenders its bond to the issuer (just as if the issuer had called the bond) and the holder of the call right purchases the bond. In some instances, issuers already have issued municipal call rights and the underlying bonds in such cases are sometimes referred to as being subject to "detached" call rights.

Bonds subject to detachable call rights generally include a provision that permits an investor that owns both the detached call right and the underlying bond to link the two instruments together, subject to certain conditions. Such "linked" municipal securities would not be subject to being called at certain times by holders of call rights or the issuer. They may, however, be subject to other calls, such as sinking fund provisions. If a customer obtains a linked security, thereafter the customer has the option to de-link the security, again subject to certain conditions, into a municipal call right and an underlying bond subject to a right of mandatory tender.

### **Applicability of Board Rules**

Of course, the Board's rules apply to bonds subject to detachable call features and "linked" securities just as they apply to all other municipal securities. The Board, however, would like to remind dealers of certain Board rules that should be considered in transactions involving these municipal securities.

#### *Rule G-15(a) on Customer Confirmations*

Rule G-15(a)(i)(E)[\*] requires customer confirmations to set forth "a description of the securities, including... if the securities are... subject to redemption prior to maturity..., an indication to such effect." Additionally, rule G-15(a)(iii)(F)[\*] requires a legend to be placed on customer confirmations of transactions in callable securities which notes that "Call features may exist which could affect yield; complete information will be provided upon request."

Confirmations of transactions in bonds subject to detachable call rights, therefore, would have to indicate this information.[1] In addition, the details of the call provisions of such securities would have to be provided to the customer upon the customer's request.

Confirmation disclosure, however, serves merely to support—not to satisfy—a dealer's general disclosure obligations. More specifically, the disclosure items required on the confirmation do not encompass "all material facts" that must be disclosed to customers at the time of trade pursuant to rule G-17.

#### *Rule G-17 on Fair Dealing*

Rule G-17 of the Board's rules of fair practice requires municipal securities dealers to deal fairly with all persons and prohibits them from engaging in any deceptive, dishonest, or unfair practice. The Board has interpreted this rule to require that a dealer must disclose, at or before the sale of municipal securities to a customer, all material facts concerning the transaction, including a complete description of the security, and must not omit any material facts which would render other statements misleading. Among other things, a dealer must disclose at the time of trade whether a security may be redeemed prior to maturity in-whole, in-part, or in extraordinary circumstances because this knowledge is essential to a customer's investment decision.

Clearly, bonds subject to detachable calls must be described as callable at the time of the trade.<sup>[2]</sup> In addition, if a dealer is asked by a customer at the time of trade for specific information regarding call features, this information must be obtained and relayed promptly.

Although the Board requires dealers to indicate to customers at the time of trade whether municipal securities are callable, the Board has not categorized which, if any, specific call features it considers to be material and therefore also must be disclosed. Instead, the Board believes that it is the responsibility of the dealer to determine whether a particular feature is material.

With regard to detachable calls, dealers must decide whether the ability of a third party to call the bond is a material fact that should be disclosed to investors. Dealers should make this determination in the same way they determine whether other facets of a municipal securities transaction are material—is it a fact that a reasonable investor would want to know when making an investment decision? For example, would a reasonable investor who knows a bond is callable base an investment decision on whether someone other than the issuer can call the bond? Does this new feature affect the pricing of the bond?

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The Board is continuing its review of detachable call rights and may take additional related action at a later date. The Board welcomes the views of all persons on the application of Board rules to transactions in securities subject to detachable call rights.

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<sup>[1]</sup> With regard to the confirmation requirement for linked securities, if these securities are subject to other call provisions such as sinking fund calls, the customer confirmation must indicate that these securities are callable.

<sup>[2]</sup> Similarly, when considering the application of rule G-17 to transactions in "linked" securities, as with other municipal securities, dealers have the obligation to ensure that investors understand the features of the security. In particular, if a linked security to other call provisions, dealers should ensure that retail customers do not mistakenly believe the bond is "non-callable."

<sup>[\*]</sup> [Currently codified at rule G-15(a)(i)(C)(2)(a)]

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#### **NOTICE CONCERNING SECURITIES THAT PREPAY PRINCIPAL - March 19, 1991**

The Board has become aware of several issues of municipal securities that prepay principal to the bondholders over the life of the issue. These securities are issued with a face value that equals the total principal amount of the securities. However, as the prepayment of principal to bondholders occurs over time, the "unpaid principal" associated with a given quantity of the securities become an increasingly lower percentage of the face amount. The Board believes that there is a possibility of confusion in transactions involving such securities, since most dealers and customers are accustomed to municipal securities in which the face amount always equals the principal amount that will be paid at maturity.

Because of the somewhat unusual nature of the securities, the Board believes that dealers should be alert to their disclosure responsibilities. For customer transactions, rule G-17 requires that the dealer disclose to its customer, at or prior to the time of trade, all material facts with respect to the proposed transaction. Because the prepayment of principal is a material feature of these securities, dealers must ensure that the customer knows that securities prepay principal. The dealer also must inform the customer of the amount of unpaid principal that will be delivered on the transaction.

For inter-dealer transactions, there is no specific requirement for a dealer to disclose all material facts to another dealer at time of trade. A selling dealer is not generally charged with the responsibility to ensure that the purchasing dealer knows all relevant features of the securities being offered for sale. The selling dealer may rely, at least to a reasonable extent, on the fact that the purchasing dealer is also a professional and will satisfy his need for information prior to entering into a contract for the securities. Nevertheless, it is possible that non-disclosure of an unusual feature such as principal prepayment might constitute an unfair practice and thus become a violation of rule G-17 even in an inter-dealer transaction. This would be especially true if the information about the prepayment feature is not accessible to the market and is intentionally withheld by the selling dealer. Whether or not non-disclosure constitutes an unfair practice in a specific case would depend upon the individual facts of the case. However, to avoid trade disputes and settlement delays in inter-dealer transactions, it generally is in dealers' interest to reach specific agreement on the existence of any prepayment feature and the amount of unpaid principal that will be delivered.

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## **NOTICE OF INTERPRETATION ON ESCROWED-TO-MATURITY SECURITIES: RULES G-17, G-12 and G-15 - September 21, 1987**

The Board is concerned that the market for escrowed-to-maturity securities has been disrupted by uncertainty whether these securities may be called pursuant to optional redemption provisions. Accordingly, the Board has issued the following interpretations of rule G-17, on fair dealing, and rules G-12(c) and G-15(a), on confirmation disclosure, concerning escrowed-to-maturity securities. The interpretations are effective immediately.

### **Background**

Traditionally, the term escrowed-to-maturity has meant that such securities are not subject to optional redemption prior to maturity. Investors and market professionals have relied on this understanding in their purchases and sales of such securities. Recently, certain issuers have attempted to call escrowed-to-maturity securities. As a result, investors and market professionals considering transactions in escrowed-to-maturity securities must review the documents for the original issue, for any refunding issue, as well as the escrow agreement and state law, to determine whether any optional redemption provisions apply. In addition, the Board understands that there is uncertainty as to the fair market price of such securities which may cause harm to investors.

On March 17, 1987, the Board sent letters to the Public Securities Association, the Government Finance Officers Association and the National Association of Bond Lawyers expressing its concern. The Board stated that it is essential that issuers, when applicable, expressly note in official statements and defeasance notices relating to escrowed-to-maturity securities whether they have reserved the right to call such securities. It stated that the absence of such express disclosure would raise concerns whether the issuer's disclosure documents adequately explain the material features of the issue and would severely damage investor confidence in the municipal securities market. Although the Board has no rulemaking authority over issuers, it advised brokers, dealers and municipal securities dealers (dealers) that assist issuers in preparing disclosure documents for escrowed-to-maturity securities to alert these issuers of the need to disclose whether they have reserved the right to call the securities since such information is material to a customer's investment decision about the securities and to the efficient trading of such securities.

### **Application of Rule G-17 on Fair Dealing**

In the intervening months since the Board's letter, the Board has continued to receive inquiries from market participants concerning the callability of escrowed-to-maturity securities. Apparently, some dealers now are describing all escrowed-to-maturity securities as callable and there is confusion how to price such securities. In order to avoid confusion with respect to issues that might be escrowed-to-maturity in the future, the Board is interpreting rule G-17,

on fair dealing,<sup>[1]</sup> to require that municipal securities dealers that assist in the preparation of refunding documents as underwriters or financial advisors alert issuers of the materiality of information relating to the callability of escrowed-to-maturity securities. Accordingly, such dealers must recommend that issuers clearly state when the refunded securities will be redeemed and whether the issuer reserves the option to redeem the securities prior to their maturity.

### **Application of Rules G-12(c) and G-15(a) on Confirmation Disclosure of Escrowed-to-Maturity Securities**

Rules G-12(c)(vi)(E) and G-15(a)(iii)(E)<sup>[\*]</sup> require dealers to disclose on inter-dealer and customer confirmations, respectively, whether the securities are "called" or "prerefunded," the date of maturity which has been fixed by the call notice, and the call price. The Board has stated that this paragraph would require, in the case of escrowed-to-maturity securities, a statement to that effect (which would also meet the requirement to state "the date of maturity which has been fixed") and the amount to be paid at redemption. In addition, rules G-12(c)(v)(E) and G-15(a)(i)(E)<sup>[†]</sup> require dealers to note on confirmations if securities are subject to redemption prior to maturity (callable).

The Board understands that dealers traditionally have used the term escrowed-to-maturity only for non-callable advance refunded issues the proceeds of which are escrowed to original maturity date or for escrowed-to-maturity issues with mandatory sinking fund calls. To avoid confusion in the use of the term escrowed-to-maturity, the Board has determined that dealers should use the term escrowed-to-maturity to describe on confirmations only those issues with no optional redemption provisions expressly reserved in escrow and refunding documents. Escrowed-to-maturity issues with no optional or mandatory call features must be described as "escrowed-to-maturity." Escrowed-to-maturity issues subject to mandatory sinking fund calls must be described as "escrowed-to-maturity" and "callable." If an issue is advance refunded to the original maturity date, but the issuer expressly reserves optional redemption features, the security should be described on confirmations as "escrowed (or prerefunded) to [the actual maturity date]" and "callable."<sup>[2]</sup>

The Board believes that the use of different terminology to describe advance refunded issues expressly subject to optional calls will better alert dealers and customers to this important aspect of certain escrowed issues.<sup>[3]</sup>

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<sup>[1]</sup> Rule G-17 states that "[i]n the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

<sup>[2]</sup> This terminology also would be used for any issue prerefunded to a call date, with an earlier optional call expressly reserved.

<sup>[3]</sup> The Board believes that, because of the small number of advance refunded issues that expressly reserve the right of the issuer to call the issue pursuant to an optional redemption provision, confirmation systems should be able to be programmed for use of the new terminology without delay.

<sup>[\*]</sup> [Currently codified at rule G-15(a)(i)(C)(3)(a). See also current rule G-15(a)(i)(C)(3)(b).]

<sup>[†]</sup> [Currently codified at rule G-15(a)(i)(C)(2)(a).]

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### **NOTICE OF INTERPRETATION REQUIRING DEALERS TO SUBMIT TO ARBITRATION AS A MATTER OF FAIR DEALING - March 6, 1987**

Section 2 of the Board's Arbitration Code, rule G-35, requires all dealers to submit to arbitration at the instance of a customer or another dealer. From time to time, a dealer will refuse to submit to arbitration or will delay or even refuse to make payment of an award. Such acts constitute violations of rule G-35. The Board believes that it is a violation of rule G-17, on fair dealing, for a broker, dealer or municipal securities dealer or its associated persons to fail to submit to arbitration as required by Rule G-35, or to fail to comply with the procedures therein, including the production of documents, or to fail to honor an award of arbitrators unless a timely motion to vacate the award has been made according to applicable law.<sup>[1]</sup>

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<sup>[1]</sup> A party typically has 90 days to seek judicial review of an arbitration award; after that the award cannot be

challenged. Challenges to arbitration awards are heard only in limited, egregious circumstances such as fraud or collusion on the part of the arbitrators.

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### **Description provided at or prior to the time of trade - April 30, 1986**

**Description provided at or prior to the time of trade.** This is in response to your February 27, 1986 letter and our prior telephone conversation concerning the application of Board rules to the description of municipal securities exchanged at or prior to the time of trade. You note that it is becoming more and more common in the municipal securities secondary market for sellers, both dealers and customers, to provide only a "limited description" and CUSIP number for bonds being sold. Recently you were asked by a customer to bid on \$4 million of bonds and were given the coupon, maturity date, and issuer. When you asked for more information, you were given the CUSIP number. You then bid on and purchased the bonds. After the bonds were confirmed, you discovered that the bonds were callable and that, when these bonds first came to market, they were priced to the call. You state that the seller was aware that the bonds were callable.

Your letter was referred to a Committee of the Board which has responsibility for interpreting the Board's fair practice rules. That Committee has authorized this response.

Board rule G-17 provides that

In the conduct of its municipal securities business, *each broker, dealer, and municipal securities dealer* shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. (emphasis added)

The Board has interpreted this rule to require that, in connection with the purchase from or sale of a municipal security to a customer, at or before execution of the transaction, a dealer must disclose all material facts concerning the transaction which could affect the customer's investment decision and not omit any material facts which would render other statements misleading. The fact that a municipal security may be redeemed in-whole, in-part, or in extraordinary circumstances prior to maturity is essential to a customer's investment decision and is one of the facts a dealer must disclose.

I note from our telephone conversation that you ask whether Board rules specify what information a customer must disclose to a dealer at the time it solicits bids to buy municipal securities. Customers are not subject to the Board's rules, and no specific disclosure rules would apply to customers beyond the application of the anti-fraud provisions of the federal securities laws. I note, however, that a municipal securities professional buying securities from a customer should obtain sufficient information about the securities so that it can accurately describe these securities when the dealer reintroduces them into the market.

In regard to inter-dealer transactions, the items of information that professionals must exchange at or prior to the time of trade are governed by principles of contract law and essentially are those items necessary adequately to describe the security that is the subject of the contract. As a general matter, these items of information may not encompass all material facts, but must be sufficient to distinguish the security from other similar issues. The Board has interpreted rule G-17 to require dealers to treat other dealers fairly and to hold them to the prevailing ethical standards of the industry. Also, dealers may not knowingly misdescribe securities to another dealer. *MSRB interpretation of April 30, 1986.*

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### **NOTICE CONCERNING THE APPLICATION OF BOARD RULES TO PUT OPTION BONDS - September 30, 1985**

The Board has received a number of inquiries from municipal securities brokers and dealers regarding the application of the Board's rules to transactions in put option bonds. Put option or tender option bonds on new issue securities are obligations which grant the bondholder the right to require the issuer (or a specified third party acting as agent for the

issuer), after giving required notice, to purchase the bonds, usually at par (the "strike price"), at a certain time or times prior to maturity (the "expiration date(s)") or upon the occurrence of specified events or conditions. Put options on secondary market securities also are coming into prominence. These instruments are issued by financial institutions and permit the purchaser to sell, after giving required notice, a specified amount of securities from a specified issue to the financial institution on certain expiration dates at the strike price. Put options generally are backed by letters of credit. Secondary market put options often are sold as an attachment to the security, and subsequently are transferred with that security. Frequently, however, the put option may be sold separately from that security and re-attached to other securities from the same issue.

Of course, the Board's rules apply to put option bonds just as they apply to all other municipal securities. The Board, however, has issued a number of interpretive letters on the specific application of its rules to these types of bonds. These interpretive positions are reviewed below.

## **Fair Practice Rules**

### **1. Rule G-17**

Board rule G-17, regarding fair dealing, imposes an obligation on persons selling put option bonds to customers to disclose adequately all material information concerning these securities and the put features at the time of trade. In an interpretive letter on this issue,<sup>[1]</sup> the Board responded to the question whether a dealer who had previously sold put option securities to a customer would be obligated to contact that customer around the time the put option comes into effect to remind the customer that the put option is available. The Board stated that no Board rule would impose such an obligation on the dealer.

In addition, the Board was asked whether a dealer who purchased from a customer securities with a put option feature at the time of the put option exercise date at a price significantly below the put exercise price would be in violation of any Board rules. The Board responded that such dealer may well be deemed to be in violation of Board rules G-17 on fair dealing and G-30 on prices and commissions.

### **2. Rule G-25(b)**

Board rule G-25(b) prohibits brokers, dealers, and municipal securities dealers from guaranteeing or offering to guarantee a customer against loss in municipal securities transactions. Under the rule, put options are not deemed to be guarantees against loss if their terms are provided in writing to the customer with or on the confirmation of the transaction and recorded in accordance with rule G-8(a)(v).<sup>[2]</sup> Thus, when a municipal securities dealer is the issuer of a secondary market put option on a municipal security, the terms of the put option must be included with or on customer confirmations of transactions in the underlying security. Dealers that sell bonds subject to put options issued by an entity other than the dealer would not be subject to this disclosure requirement.

## **Confirmation Disclosure Rules**

### **1. Description of Security**

Rules G-12(c)(v)(E) and G-15(a)(i)(E)<sup>[\*]</sup> require inter-dealer and customer confirmations to set forth

a description of the securities, including... if the securities are... subject to redemption prior to maturity, an indication to such effect.

Confirmations of transactions in put option securities, therefore, would have to indicate the existence of the put option (e.g., by including the designation "puttable" on the confirmation), much as confirmations concerning callable securities must indicate the existence of the call feature. The confirmation need not set forth the specific details of the put option feature.<sup>[3]</sup>

Rules G-12(c)(v)(E) and G-15(a)(i)(E)<sup>[†]</sup> also require confirmations to contain

a description of the securities including at a minimum... if necessary for a materially complete description of the securities, the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to debt service...

The Board has stated that a bank issuing a letter of credit which secures a put option feature on an issue is "obligated... with respect to debt service" on such issue. Thus, the identity of the bank issuing the letter of credit securing the put option also must be indicated on the confirmation.<sup>[4]</sup>

Finally, rules G-12(c)(v)(E) and G-15(a)(i)(E)<sup>[4]</sup> requires that dealer and customer confirmations contain a description of the securities including, among other things, the interest rate on the bonds. The Board has interpreted this provision as it pertains to certain tender option bonds with adjustable tender fees to require that the net interest rate (*i.e.*, the current effective interest rate taking into account the tender fee) be disclosed in the interest rate field and that dealers include elsewhere in the description field of the confirmation the stated interest rate with the phrase "less fee for put."<sup>[5]</sup>

## 2. Yield Disclosure

Board rule G-12(c)(v)(I) requires that inter-dealer confirmations include the

yield at which transaction was effected and resulting dollar price, except in the case of securities which are traded on the basis of dollar price or securities sold at par, in which event only dollar price need be shown (in cases in which securities are priced to call or to par option, this must be stated and the call or option date and price used in the calculation must be shown, and where a transaction is effected on a yield basis, the dollar price shall be calculated to the lowest of price to call, price to par option, or price to maturity);

Rule G-15(a)(i)(I)<sup>[#]</sup> requires that customer confirmations include information on yield and dollar price as follows:

- (1) for transactions effected on a yield basis, the yield at which transaction was effected and the resulting dollar price shall be shown. Such dollar price shall be calculated to the lowest of price to call, price to par option, or price to maturity.
- (2) for transactions effected on the basis of dollar price, the dollar price at which transaction was effected, and the lowest of the resulting yield to call, yield to par option, or yield to maturity shall be shown.
- (3) for transactions at par, the dollar price shall be shown.

In cases in which the resulting dollar price or yield shown on the confirmation is calculated to call or par option, this must be stated, and the call or option date and price used in the calculation must be shown.

Neither of these rules requires the presentation of a yield or a dollar price computed to the put option date as a part of the standard confirmation process. In many circumstances, however, the parties to a particular transaction may agree that the transaction is effected on the basis of a yield to the put option date, and that the dollar price will be

computed in this fashion. If that is the case, the yield to the put date must be included on confirmations as the yield at which the transaction was effected and the resulting dollar price computed to the put date, together with a statement that it is a "yield to the [date] put option" and an indication of the date the option first becomes available to the holder. [6] The requirement for transactions effected on a yield basis of pricing to the lowest of price to call, price to par option or price to maturity, applies only when the parties have not specified the yield on which the transaction is based.

In addition, in regard to transactions in tender option bonds with adjustable tender fees, even if the transaction is not effected on the basis of a yield to the tender date, dealers must include the yield to the tender date since an accurate yield to maturity cannot be calculated for these securities because of the yearly adjustment in tender fees. [7]

## **Delivery Requirements**

In a recent interpretive letter, the Board responded to an inquiry whether, in three situations, the delivery of securities subject to put options could be rejected. [8] The Board responded that, in the first situation in which securities subject to a "one time only" put option were purchased for settlement prior to the option expiration date but delivered after the option expiration date, such delivery could be rejected since the securities delivered were no longer "puttable" securities. In the second situation in which securities subject to a "one time only" put option were purchased for settlement prior to the option expiration date and delivered prior to that date, but too late to permit the recipient to satisfy the conditions under which it could exercise the option (e.g., the trustee is located too far away for the recipient to be able to present the physical securities by the expiration date), the Board stated that there might not be a basis for rejecting delivery, since the bonds delivered were "puttable" bonds, depending on the facts and circumstances of the delivery. A purchasing dealer who believed that it had incurred some loss as a result of the delivery would have to seek redress in an arbitration proceeding.

Finally, in the third situation, securities which were the subject of a put option exercisable on a stated periodic basis (e.g., annually) were purchased for settlement prior to the annual exercise date so that the recipient was unable to exercise the option at the time it anticipated being able to do so. The Board stated that this delivery could not be rejected since "puttable" bonds were delivered. A purchasing dealer who believed that it had incurred some loss as a result of the delivery would have to seek redress in an arbitration proceeding.

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[1] See [Rule G-17 Interpretive Letter - Put option bonds: safekeeping, pricing,] MSRB interpretation of February 18, 1983.

[2] Rule G-8(a)(v) requires dealers to record, among other things, oral or written put options with respect to municipal securities in which such municipal securities broker or dealer has any direct or indirect interest, showing the description and aggregate par value of the securities and the terms and conditions of the option.

[3] See [Rule G-12 Interpretive Letter - Confirmation disclosure: put option bonds,] MSRB interpretation of April 24, 1981.

[4] See [Rule G-15 Interpretive Letter - Securities description: securities backed by letters of credit,] MSRB interpretation of December 2, 1982.

[5] See [Rule G-12 Interpretive Letter - Confirmation disclosure: tender option bonds with adjustable tender fees,] MSRB interpretation of March 5, 1985.

[6] See [Rule G-12 Interpretive Letter - Confirmation disclosure: put option bonds,] MSRB interpretation of April 24, 1981.

[7] See fn. 5.

[8] See [Rule G-12 Interpretive Letter - Delivery requirements: put option bonds,] MSRB interpretation of February 27, 1985.

[\*] [Currently codified at rule G-15(a)(i)(C)(2)(a). See also current rule G-15(a)(i)(C)(2)(b).]

[†] [Currently codified at rule G-15(a)(i)(C)(1)(b).]

[‡] [Currently codified at rule G-15(a)(i)(B)(4). See also current rule G-15(a)(i)(B)(4)(c).]

[#] [Currently codified at rule G-15(a)(i)(A)(5). See also current rule G-15(a)(i)(A)(5)(c)(vi)(D).]

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#### **SYNDICATE MANAGERS CHARGING EXCESSIVE FEES FOR DESIGNATED SALES - July 29, 1985**

The Board has received inquiries concerning situations in which syndicate managers charge fees for designated sales that do not appear to be actual expenses incurred on behalf of the syndicate or may appear to be excessive in amount. For example, one commentator has described a situation in which the syndicate managers charge \$.25 to \$.40 per bond as expenses on designated sales and has suggested that such a charge seems to bear no relation to the actual out-of-pocket costs of handling such transactions.

G-17 provides that

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

The Board wishes to emphasize that syndicate managers should take care in determining the actual expenses involved in handling designated sales and may be acting in violation of rule G-17 if the expenses charged to syndicate members bear no relation to or otherwise overstate the actual expenses incurred on behalf of the syndicate.

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#### **ALTERING THE SETTLEMENT DATE ON TRANSACTIONS IN "WHEN-ISSUED" SECURITIES - February 26, 1985**

The Board has received inquiries concerning situations in which a municipal securities dealer alters the settlement date on transactions in "when-issued" securities. In particular, the Board has been made aware of a situation in which a dealer sells a "when-issued" security but accepts the customer's money prior to the new issue settlement date and specifies on the confirmation for the transaction a settlement date that is weeks before the actual settlement date of the issue. The dealer apparently does this in order to put the customer's money "to work" as soon as possible. The Board is of the view that this situation is one in which a customer deposits a free credit balance with the dealer and then, using this balance, purchases securities on the actual settlement date. The dealer pays interest on the free credit balance at the same rate as the securities later purchased by the customer.

Rule G-17 provides that

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

The Board believes that this practice would violate rule G-17 if the customer is not advised that the interest received on the free credit balance would probably be taxable. In addition, the Board notes that a dealer that specifies a fictitious settlement date on a confirmation would violate rule G-15(a) which requires that the settlement date be included on customer confirmations.

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#### **SYNDICATE MANAGER SELLING SHORT FOR OWN ACCOUNT TO DETRIMENT OF SYNDICATE ACCOUNT - December 21, 1984**

The Board has received an inquiry concerning a situation in which a municipal securities dealer that is acting as a syndicate manager sells bonds "short" for its own account to the detriment of the syndicate account. In particular, the Board has been made aware of allegations that certain syndicate managers, with knowledge that the syndicate account on a particular new issue of securities is not successful, have sold securities of the new issue "short" for their own accounts and then required syndicate members to take their allotments of unsold bonds. The syndicate managers allegedly have subsequently covered their short positions when the syndicate members attempt to sell their allotments at the lower market price.

Rule G-17, the Board's fair dealing rule, provides:

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

Syndicate managers act in a fiduciary capacity in relation to syndicate accounts. Therefore they may not use proprietary information about the account obtained solely as a result of acting as manager to their personal advantage over the syndicate's best interests. The Board is of the view that a syndicate manager that uses information on the status of the syndicate account which is not available to syndicate members to its own benefit and to the detriment of the syndicate account (e.g., by effecting "short sale" transactions for its own account against the interests of other syndicate members) appears to be acting in violation of the fair dealing provisions of rule G-17.

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#### **APPLICATION OF BOARD RULES TO TRANSACTIONS IN MUNICIPAL SECURITIES SUBJECT TO SECONDARY MARKET INSURANCE OR OTHER CREDIT ENHANCEMENT FEATURES - March 6, 1984**

It has come to the Board's attention that insurance companies are offering to insure whole maturities of issues of municipal securities outstanding in the secondary market. The Board understands that municipal securities professionals must apply for the insurance which, once issued, will remain in effect for the life of the security. The Board further understands that other credit enhancement devices also may be developed for secondary market issues.

The Board wishes to remind the industry of the application of rule G-17, the Board's fair dealing rule, in connection with transactions with customers in securities that are subject to secondary market insurance or other credit enhancement devices or in securities for which arrangements for such insurance or device have been initiated.<sup>[1]</sup> The Board is of the view that facts, for example, that a security has been insured or arrangements for insurance have been initiated, that will affect the market price of the security are material and must be disclosed to a customer at or before execution of a transaction in the security. In addition, the Board believes that a dealer should advise a customer if evidence of insurance or other credit enhancement feature must be attached to the security for effective transference of the insurance or device.<sup>[2]</sup>

The Board also wishes to remind the industry that under rule G-13, concerning quotations, all quotations relating to municipal securities made by a dealer must be based on the dealer's best judgment of the fair market value of the securities at the time the quotation is made. Offers to buy securities that are insured or otherwise have a credit enhancement feature, or for which arrangements for insurance or other credit enhancement have been initiated, must comply with rule G-13. Similarly, the prices at which these securities are purchased or sold by a municipal securities dealer must be fair and reasonable to its customers under Board rule G-30 on prices and commissions.

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<sup>[1]</sup> Rule G-17 provides:

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any

deceptive, dishonest, or unfair practice.

[2] The Board has adopted amendments to rule G-15 which, among other things, require that deliveries to customers of insured securities be accompanied by some evidence of the insurance.

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#### **NOTICE CONCERNING APPLICATION OF RULE G-17 TO USE OF LOTTERIES TO ALLOCATE PARTIAL CALLS TO SECURITIES HELD IN SAFEKEEPING - March 6, 1984**

The Board has received inquiries concerning the duty of municipal securities brokers and dealers to allocate partial calls fairly among customer securities held in safekeeping. In particular, it has come to the Board's attention that certain municipal securities dealers use lottery systems that include only customer positions and exclude the dealer's proprietary accounts when the call is exercised at a price below the current market value.

The Board recognizes that lottery systems are a proper method of allocating the results of a partial call. Principles of fair dealing require that all such lotteries treat dealer and customer account alike. The Board is of the view that a municipal securities dealer which uses a lottery that excludes the dealer's proprietary accounts when the call is exercised at a price below the current market value is acting in violation of rule G-17, the Board's fair dealing rule.[1]

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[1] Rule G-17 provides:

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

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#### **NOTICE OF INTERPRETATION OF RULE G-17 CONCERNING PROMPT DELIVERY OF SECURITIES - October 13, 1983**

From time to time the Board has received inquiries from purchasers of municipal securities concerning the duty of municipal securities brokers and dealers to deliver securities to customers under the Board's rules. In particular, customers have asked what, if any, remedies are available when long delays occur between the purchase, payment and delivery of municipal securities. The Board has advised such individuals that under rule G-17, the Board's fair dealing rule, a municipal securities broker or dealer has a duty to deliver securities sold to customers in a prompt fashion.

The Board is mindful that a dealer's failure to deliver municipal securities often is caused by its failure to receive delivery of the securities from another dealer or by other circumstances beyond its control. It nevertheless believes that a dealer's duty to deliver securities promptly to customers is inherent in rule G-17.[1] A violation of that duty could occur, for example, if a dealer sells securities to a customer when it knows that it cannot effect delivery by the specified settlement date or within a reasonable length of time thereafter and does not disclose that fact to its customer.

The Board notes that customers who fail to receive securities are not entitled to take advantage of the Board's procedures to close out a failed transaction which are available only for inter-dealer transactions under rule G-12. However, if a customer sustains a loss or otherwise is damaged by his dealer's failure to deliver securities, he may seek recovery through the Board's arbitration program or through litigation. These remedies may accrue to the customer whether or not a dealer's failure to deliver violates rule G-17.

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[1] The duty of a securities professional to complete promptly transactions with customers also has been found to flow

from the federal securities laws by the SEC and the courts.

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### **Put option bonds: safekeeping, pricing - February 18, 1983**

**Put option bonds: safekeeping, pricing.** I am writing in response to your recent letter regarding issues of municipal securities with put option or tender option features, under which a holder of the securities may put the securities back to the issuer or an agent of the issuer at par on certain stated dates. In your letter you inquire generally as to the confirmation disclosure requirements applicable to such securities. You also raise several questions regarding a dealer's obligation to advise customers of the existence of the put option provision at times other than the time of sale of the securities to the customer.

Your letter was referred to a committee of the Board which has responsibility for interpreting the Board's confirmation rules, among other matters. That committee has authorized my sending you the following response.

Both rules G-12(c) and G-15, applicable to inter-dealer and customer confirmations respectively, require that confirmations of transactions in securities which are subject to put option or tender option features must indicate that fact (e.g., through inclusion of the designation "puttable" on the confirmation). the date on which the put option feature first comes into effect need be stated on the confirmation only if the transaction is effected on a yield basis and the parties to the transaction specifically agree that the transaction dollar price should be computed to that date. In the absence of such an agreement, the put date need not be stated on the confirmation, and any yield disclosed should be a yield to maturity.

Of course, municipal securities brokers and dealers selling to customers securities with put option or tender option features are obligated to disclose adequately the special characteristics of these securities at the time of trade. The customer therefore should be advised of information about the put option or tender option feature at this time.

In your letter you inquire whether a dealer who had previously sold securities with a put option or tender option feature to a customer would be obliged to contact that customer around the time the put option comes into effect to remind the customer that the put option is available. You also ask whether such an obligation would exist if the dealer held the securities in safekeeping for the customer. The committee can respond, of course, only in terms of the requirements of Board rules; the committee noted that no Board rule would impose such an obligation on the dealer.

In your letter you also ask whether a dealer who purchased from a customer securities with a put option or tender option feature at the time of the put option exercise date at a price significantly below the put exercise price would be in violation of any Board rules. The committee believes that such a dealer might well be deemed to be in violation of Board rules G-17 on fair dealer and G-30 on prices and commissions. *MSRB interpretation of February 18, 1983.*

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### **"Wooden tickets" - March 3, 1981**

**"Wooden tickets."** This is in response to your letter of February 4, 1981 asking whether the practice of a broker-dealer using "wooden tickets" is prohibited by Board rule G-17. According to your letter, this practice refers to the mailing of confirmations of sales to customers who, in fact, have not placed orders to purchase securities. Thereafter, if any customer objects, stating that it never authorized the transaction, the sale is canceled. You state that, in some cases, customers accept the transaction and make payment.

The Board has determined that the practice by a municipal securities dealer of knowingly issuing confirmations of sales to customers who have not placed orders to purchase the bonds is a deceptive, dishonest, and unfair practice under rule G-17. *MSRB interpretation of March 3, 1981.*

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