

Proposed Rule Change by Municipal Securities Rulemaking Board
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial <input checked="" type="checkbox"/>	Amendment <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) <input checked="" type="checkbox"/>	Section 19(b)(3)(A) <input type="checkbox"/>	Section 19(b)(3)(B) <input type="checkbox"/>
Pilot <input type="checkbox"/>			Rule		
Extension of Time Period for Commission Action <input type="checkbox"/>		Date Expires <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document <input checked="" type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>
-------------------------------------------------------------------------	--------------------------------------------------------------

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

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

First Name	<input type="text" value="Jill"/>	Last Name	<input type="text" value="Finder"/>
Title	<input type="text" value="Assistant General Counsel"/>		
E-mail	<input type="text" value="jfinder@msrb.org"/>		
Telephone	<input type="text" value="(703) 797-6600"/>	Fax	<input type="text" value="(703) 797-6700"/>

Signature
Pursuant to the requirements of the Securities Exchange Act of 1934,
Municipal Securities Rulemaking Board
has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date	<input type="text" value="11/24/2006"/>
By	<input type="text" value="Ronald W. Smith"/> (Name)
	<input type="text" value="Corporate Secretary"/> (Title)

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

Ronald Smith, rsmith@msrb.org

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

Form 19b-4 Information

Add Remove View

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

Exhibit 1 - Notice of Proposed Rule Change

Add Remove View

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

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

Add Remove View

Exhibit Sent As Paper Document

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

Exhibit 3 - Form, Report, or Questionnaire

Add Remove View

Exhibit Sent As Paper Document

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

Exhibit 4 - Marked Copies

Add Remove View

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

Exhibit 5 - Proposed Rule Text

Add Remove View

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

Partial Amendment

Add Remove View

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

1. Text of Proposed Rule Change

(a) The Municipal Securities Rulemaking Board (“MSRB” or “Board”) is hereby filing with the Securities and Exchange Commission (“Commission” or “SEC”) proposed amendments to Rule G-27, on supervision, Rule G-8, on recordkeeping, and Rule G-9, on record retention, that would more fully conform MSRB rules to NASD requirements relating to supervision. The MSRB has proposed that the amendments become effective six months after Commission approval of the proposed rule change. The proposed rule change is as follows:¹

Rule G-27: Supervision

(a) *Obligation to supervise.* Each broker, dealer and municipal securities dealer ("dealer") shall supervise the conduct of the municipal securities activities of the dealer and its associated persons to ensure compliance with Board rules and the applicable provisions of the Act and rules thereunder (“applicable rules”).

(b) *Supervisory System.* Each dealer shall establish and maintain a system to supervise the municipal securities activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable Board rules. Final responsibility for proper supervision shall rest with the dealer. A dealer’s supervisory system shall provide, at a minimum, for the following:

(i) The establishment and maintenance of written procedures as required by sections (c), (d), (e) and (f) of this rule.

(ii)(A) *General.* The designation of one or more associated persons qualified as municipal securities principals, municipal securities sales principals, municipal fund securities limited principals, financial and operations principals in accordance with Board rules, or as general securities principals to be responsible for the supervision of the municipal securities activities of the dealer and its associated persons as required by this rule.

(B) *Written Record.* A written record of each supervisory designation and of the designated principal's responsibilities under this rule shall be maintained and updated as required under Rule G-9.

(C) *Appropriate Principal.* Each dealer shall designate a municipal securities principal as responsible for its supervision under sections (a), (c), (d), (e) and (f) of this rule, except as provided in this section. A non-bank dealer shall designate a financial and operations principal as responsible for the financial reporting duties specified in Rule G-3(d)(i)(A-E) and with primary responsibility

¹ Underlining indicates new language; [brackets] indicate deletions.

for books and records under paragraph (c)(i)(E) below; provided, however, that a non-bank dealer meeting the requirements of Securities Exchange Act Rule 15c3-1(a)(2)(iv), (v) or (vi) or the exemption under Rule 15c3-1(b)(3) may, but is not required to, designate a financial and operations principal as responsible for such financial reporting duties and with primary responsibility for such books and records. In addition, a municipal securities sales principal may be designated as responsible for supervision under paragraphs (c)(i)(B), (C) and (G) and subsection (e)(i) of this rule, to the extent the activities pertain to sales to or purchases from a customer; a general securities principal may be designated as responsible for supervision under paragraph (c)(i)(E) and subparagraph (c)(i)(G)(1) of this rule and under Rules G-7(b) and G-21(e); and a financial and operations principal may be designated as responsible for supervision under paragraph (c)(i)(F) of this rule. A municipal fund securities limited principal may be designated as responsible for supervision under sections (a), (c), (d), (e) and (f) of this rule to the extent that the activities pertain solely to transactions in municipal fund securities.

(iii) The designation as an office of supervisory jurisdiction of each location that meets the definition contained in section (g) of this rule. Each dealer shall also designate such other offices of supervisory jurisdiction as it determines to be necessary in order to supervise its registered representatives, registered principals, and other associated persons in accordance with the standards set forth in this rule, taking into consideration the following factors:

(A) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(C) whether the location is geographically distant from another office of supervisory jurisdiction of the dealer;

(D) whether the dealer's registered persons are geographically dispersed;
and

(E) whether the securities activities at such location are diverse and/or complex.

(iv) The designation of one or more appropriately registered principals in each office of supervisory jurisdiction, including the main office, and one or more appropriately registered representatives or principals in each non-office of supervisory jurisdiction branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer.

(v) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(vi) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(vii) The participation of each registered representative and registered principal, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the dealer at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's(') or principal's(') place of business.

[(b) *Designation of principals.*

(i) *General.* Each dealer shall specifically designate one or more associated persons qualified as municipal securities principals, municipal securities sales principals, financial and operations principals in accordance with Board rules, or as general securities principals to be responsible for the supervision of the municipal securities activities of the dealer and its associated persons as required by this rule.

(ii) *Written Record.* A written record of each supervisory designation and of the designated principal's responsibilities under this rule shall be maintained and updated as required under rule G-9.

(iii) *Appropriate principal.* Each dealer shall designate a municipal securities principal as responsible for its supervision under sections (a) and (c) of this rule, except as provided in this section. A non-bank dealer shall designate a financial and operations principal as responsible for the financial reporting duties specified in rule G-3(d)(i)(A-E) and with primary responsibility for books and records under section (c)(v) below; provided, however, that a non-bank dealer meeting the requirements of Securities Exchange Act rule 15c3-1(a)(2)(iv), (v) or (vi) or the exemption under rule 15c3-1(b)(3) may, but is not required to, designate a financial and operations principal as responsible for such financial reporting duties and with primary responsibility for such books and records. In addition, a municipal securities sales principal may be designated as responsible for supervision under sections (c)(ii), (iii) and (vii) of this rule, to the extent the activities pertain to sales to or purchases from a customer; a general securities principal may be designated as responsible for supervision under sections (c)(v) and (vii)(A) of this rule and under rules G-7(b) and G-21(e); and a financial and operations principal may be designated as responsible for supervision under section (c)(vi) of this rule.]

(c) *Written supervisory procedures.*

(i) General provisions. Each dealer shall adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance as required in section (a) of this rule. Such procedures shall codify the dealer's supervisory system for ensuring compliance and, at a minimum, shall establish procedures

(A) [(i)] that state how a designated principal shall monitor for compliance by the dealer with all applicable rules and supervise the activities of associated persons specified in [r]Rule G-3(a)(i);

(B) [(ii)] a designated principal shall follow when a customer complaint concerning the dealer's municipal securities activities is received;

(C) [(iii)] 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; such review shall be designed to ensure that such transactions are in accordance with all applicable rules and to detect and prevent irregularities and abuses;

(D) [(iv)] for the periodic review by a designated principal of each office which engages in municipal securities activities pursuant to section (d) of this rule;

(E) [(v)] for the maintenance and preservation, by a designated principal, of the books and records required to be maintained and preserved by [r]Rules G-8 and G-9 of the Board;

(F) [(vi)] for the supervision by a designated principal of the processing, clearance, and in the case of a non-bank dealer safekeeping of municipal securities; and

(G) [(vii)] for the prompt review and written approval by a designated principal of:

(1) [(A)] the opening of each customer account introduced or carried by the dealer in which transactions in municipal securities may be effected; and

(2) [(B)] each transaction in municipal securities on a daily basis, including each transaction in municipal securities effected with or for a discretionary account introduced or carried by the dealer.

(ii) Provisions concerning tape recording of conversations.

(A) Each dealer that either is notified by the applicable regulatory authority (as defined in subsection (g)(iii)) or otherwise has actual knowledge that

it meets one of the criteria in paragraph (c)(ii)(H) relating to the employment history of its registered persons at a disciplined firm (as defined in subsection (g)(v)) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B) The dealer must establish and implement the supervisory procedures required by this subsection (ii) within 60 days of receiving notice from the applicable regulatory authority or obtaining actual knowledge that it is subject to the provisions of this subsection.

A dealer that meets one of the criteria in paragraph (c)(ii)(H) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice from the applicable regulatory authority or obtaining actual knowledge that it is subject to the provisions of paragraph (c)(ii)(H), provided the dealer promptly notifies the applicable regulatory authority in writing of its becoming subject to this rule. Once the dealer has reduced its staffing levels to fall below the threshold levels, it shall not rehire a person terminated to accomplish the staff reduction for a period of 180 days. On or prior to reducing staffing levels pursuant to this paragraph (B), a dealer must provide the applicable regulatory authority with written notice identifying the terminated person(s).

(C) The procedures required by this subsection shall include tape-recording all telephone conversations between the dealer's registered persons and both existing and potential customers.

(D) The dealer shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this subsection to ensure compliance with applicable securities laws and regulations and applicable rules. The procedures must be appropriate for the dealer's business, size, structure, and customers.

(E) All tape recordings made pursuant to the requirements of this subsection shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each dealer shall catalog the retained tapes by registered person and date.

(F) Such procedures shall be maintained for a period of three years from the date that the dealer establishes and implements the procedures required by the provisions of this subsection.

(G) By the 30th day of the month following the end of each calendar quarter, each dealer subject to the requirements of this subsection shall submit to the applicable regulatory authority a report on the dealer's supervision of the telemarketing activities of its registered persons.

(H) The following dealers shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

(1) A dealer with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

(2) A dealer with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

(3) A dealer with at least twenty registered persons, where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years.

(4) For purposes of the calculations required in paragraph (H), dealers should not include registered persons who:

(a) have been registered for an aggregate total of 90 days or less with one or more disciplined firms within the past three years; and

(b) do not have a disciplinary history (as defined in subsection (g)(vi)).

(I) The applicable regulatory authority, upon application and pursuant to such procedures as such authority shall prescribe, may in exceptional circumstances, taking into consideration all relevant factors, exempt such dealer unconditionally or on specified terms and conditions from the requirements of this subsection (ii). A dealer seeking an exemption must file a written application within 30 days after receiving notice from the applicable regulatory authority or obtaining actual knowledge that it meets one of the criteria in paragraph (c)(ii)(H). A dealer that meets one of the criteria in paragraph (c)(ii)(H) for the first time may elect to reduce its staffing levels pursuant to the provisions of paragraph (c)(ii)(B) or, alternatively, to seek an exemption pursuant to paragraph (c)(ii)(I), as appropriate; such a dealer may not seek relief from this rule by both reducing its staffing levels pursuant to paragraph (c)(ii)(B) and requesting an exemption.

(iii) Availability of and revisions to written supervisory procedures. A copy of a dealer's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each office of supervisory jurisdiction and at each location where supervisory activities are conducted on behalf of the dealer. Each dealer shall amend its written supervisory procedures as appropriate within a reasonable time after changes

occur in Board or other applicable rules and as changes occur in its supervisory system, and each dealer shall be responsible for communicating amendments through its organization.

(d) Internal Inspections.

(i) Each dealer shall conduct a review, at least annually, of the municipal securities activities in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable Board rules. Each dealer shall review the municipal securities activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.

(A) Each dealer shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.

(B) Each dealer shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the dealer shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a dealer establishes a more frequent inspection cycle, the dealer must ensure that at least every three years, the inspection requirements enumerated in subsection (d)(ii) have been met. The non-supervisory branch office examination cycle, an explanation of the factors the dealer used in determining the frequency of the examinations in the cycle, and the manner in which a dealer will comply with subsection (d)(ii) if using more frequent inspections than every three years shall be set forth in the dealer's written supervisory and inspection procedures.

(C) Each dealer shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the dealer shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the dealer determined the frequency of the examination schedule shall be set forth in the dealer's written supervisory and inspection procedures.

Each dealer shall retain a written record of the dates upon which each review and inspection is conducted.

(ii) An office inspection and review by a dealer pursuant to subsection (d)(i) must be reduced to a written report and kept on file by the dealer for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (d)(i)(C) and the regular

periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and verification of the dealer's policies and procedures, including supervisory policies and procedures in the following areas:

- (A) Safeguarding of customer funds and securities;
- (B) Maintaining books and records;
- (C) Supervision of customer accounts serviced by branch office managers;
- (D) Transmittal of funds between customers and registered representatives and between customers and third parties;
- (E) Validation of customer address changes; and
- (F) Validation of changes in customer account information.

If a dealer does not engage in all of the activities enumerated above, the dealer must identify those activities in which it does not engage in the written inspection report and document in the report that supervisory policies and procedures for such activities must be in place before the dealer can engage in them.

(iii) An office inspection by a dealer pursuant to subsection (d)(i) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). However, if a dealer is so limited in size and resources that it cannot comply with this limitation (e.g., a dealer with only one office or a dealer has a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the dealer may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The dealer, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.

A dealer must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection (d)(iii) only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this subsection only, when

calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a dealer's internal allocation of such revenue. A dealer must calculate the 20% threshold on a rolling, twelve-month basis.

(e) [(d)] *Review of Correspondence.*

(i) Supervision of Municipal Securities Representatives. Each dealer shall establish procedures for the review by a designated principal of incoming and outgoing written (i.e., non-electronic) and electronic correspondence of its municipal securities representatives with the public relating to the municipal securities activities of such dealer. Such procedures must be in writing and be designed to reasonably supervise each municipal securities representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available, upon request, to a registered securities association or the appropriate regulatory agency [as defined in section 3(a)(34) of the Act].

(ii) Review of correspondence. Each dealer shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its municipal securities activities, including review for compliance with Rule G-21(e)(vii) to the extent applicable to such dealer's business. Procedures shall include the review of incoming, written correspondence directed to municipal securities representatives and related to the dealer's municipal securities activities to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with the dealer's procedures. Where such procedures for the review of correspondence do not require review of all correspondence prior to use or distribution, they must include provisions for the education and training of associated persons as to the dealer's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(iii) Retention of correspondence. Each dealer shall retain correspondence of municipal securities representatives relating to its municipal securities activities in accordance with [r]Rules G-8(a)(xx) and G-9(b)(viii) and (xiv). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available, upon request, to a registered securities association or the appropriate regulatory agency [as defined in Section 3(a)(34) of the Act].

[(e)] Duty to update and review written procedures. Each dealer shall revise and update its written supervisory procedures as necessary to respond to changes in Board or other applicable rules and as other circumstances require. In addition, each dealer shall review, at least on an annual basis, its supervisory system and written supervisory procedures

adopted under sections (c) and (d) of this rule to determine whether they are adequate and up-to-date and shall ensure that the dealer is in compliance with this rule.]

(f) Supervisory Control System.

(i) Each dealer shall designate one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the dealer's supervisory procedures are reasonably designed with respect to the municipal securities activities of the dealer and its registered representatives and associated persons to achieve compliance with applicable rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the dealer's senior management no less than annually a report detailing each dealer's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

(ii) The establishment, maintenance, and enforcement of written supervisory control policies and procedures pursuant to subsection (f)(i) shall include:

(A) procedures that are reasonably designed to review and supervise the customer account activity conducted by the dealer's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

(1) General Supervisory Requirement. A person who is either senior to, or otherwise independent of, the producing manager must perform such supervisory reviews. For purposes of this rule, an "otherwise independent" person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less.

(2) "Limited Size and Resources" Exception. If a dealer is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to subparagraph (1) above (e.g., a dealer has only one office or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a principal who is sufficiently knowledgeable of the dealer's supervisory control procedures, provided that the reviews are in compliance with subparagraph (1) to the extent practicable.

(3) Notification Requirement. If a dealer determines that it must rely on the "limited size and resources" exception set forth in subparagraph (2) above to conduct any of its producing managers' supervisory reviews, the dealer must notify the applicable regulatory authority through an electronic process (or any other process prescribed by such authority) within 30 days of the date on which the dealer first relies on the exception, and annually thereafter. If a dealer subsequently determines that it no longer needs to rely on the exception to conduct any of its producing managers' supervisory reviews, the dealer must, within 30 days of ceasing to rely on the exception, notify the applicable regulatory authority by using the electronic process or any other process prescribed by such authority.

(4) Documentation Requirement. A dealer relying on subparagraph (2) above must document in its supervisory control procedures the factors used to determine that complete compliance with all of the provisions of subparagraph (1) is not possible and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of subparagraph (1) above to the extent practicable.

(B) procedures that are reasonably designed to review and monitor the following activities:

(1) all transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

(2) customer changes of address and the validation of such changes of address; and

(3) customer changes of investment objectives and the validation of such changes of investment objectives.

The policies and procedures established pursuant to this paragraph (f)(ii)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented. If a dealer does not engage in all of the activities enumerated above, the dealer must identify those activities in which it does not engage in its written supervisory control policies and procedures and document in those policies and procedures that additional supervisory policies and procedures for such activities must be in place before the dealer can engage in them; and

(C) procedures that are reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. For the purposes of this subsection only, the term "heightened supervision" shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the producing manager or the producing manager's office shall be attributed as revenue generated by the business units supervised by the producing manager's supervisor irrespective of a dealer's internal allocation of such revenue. A dealer must calculate the 20% threshold on a rolling, twelve-month basis.

(g) Definitions. For purposes of this rule, the following terms have the following meanings:

(i) "Office of supervisory jurisdiction" means any office of a dealer at which any one or more of the following functions take place:

(A) order execution and/or market making;

(B) structuring of public offerings or private placements;

(C) maintaining custody of customers' funds and/or securities;

(D) final acceptance (approval) of new accounts on behalf of the dealer;

(E) review and endorsement of customer orders, pursuant to subparagraph (c)(i)(G)(2) above;

(F) final approval of advertising or sales literature for use by persons associated with the dealer, pursuant to Rule G-21(f); or

(G) responsibility for supervising the activities of persons associated with the dealer at one or more other branch offices of the dealer.

(ii)(A) A "branch office" is any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any municipal security, or is held out as such, excluding:

(1) Any location that is established solely for customer service and/or back office type functions where no sales activities are conducted and that is not held out to the public as a branch office;

(2) Any location that is the associated person's primary residence; provided that

(a) Only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location;

(b) The location is not held out to the public as an office and the associated person does not meet with customers at the location;

(c) Neither customer funds nor securities are handled at that location;

(d) The associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, advertisements and other communications to the public by such associated person;

(e) The associated person's correspondence and communications with the public are subject to the dealer's supervision in accordance with this rule;

(f) Electronic communications (e.g., e-mail) are made through the dealer's electronic system;

(g) All orders are entered through the designated branch office or an electronic system established by the dealer that is reviewable at the branch office;

(h) Written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the dealer; and

(i) A list of the residence locations is maintained by the dealer;

(3) Any location, other than a primary residence, that is used for municipal securities activities for less than 30 business days in any one calendar year, provided the dealer complies with the provisions of clauses (ii)(A)(2)(a) through (h) above;

(4) Any office of convenience, where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public as an office. Where such office of convenience is located on bank premises, signage necessary to comply

with applicable federal and state laws, rules and regulations, and applicable rules and regulations of any self-regulatory organizations and securities and banking regulators, may be displayed and shall not be deemed “holding out” for the purposes of this section;

(5) Any location that is used primarily to engage in non-securities activities and from which the associated person(s) effects no more than 25 securities transactions in any one calendar year; provided that any advertisement or sales literature identifying such location also sets forth the address and telephone number of the location from which the associated person(s) conducting business at the non-branch locations are directly supervised;

(6) The floor of a registered national securities exchange where a dealer conducts a direct access business with public customers; or

(7) A temporary location established in response to the implementation of a business continuity plan.

(B) Notwithstanding the exclusions in paragraph (ii)(A), any location that is responsible for supervising the activities of persons associated with the dealer at one or more non-branch locations of the dealer is considered to be a branch office.

(C) The term "business day" as used in paragraph (ii)(A) shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

(iii) “Applicable regulatory authority” means (i) with respect to a dealer that is a member of a registered securities association, such registered securities association, and (ii) with respect to any other dealer, the appropriate regulatory agency as defined in Section 3(a)(34) of the Act.

(iv) "Registered person" means any person qualified to act as a representative, principal or limited principal pursuant to Rule G-3.

(v) "Disciplined firm" means either a dealer that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer; or a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or a futures commission merchant or

introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the Securities and Exchange Commission revoking its registration as a broker or dealer.

(vi) "Disciplinary history" means a finding of violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the following rules (or comparable foreign provision): Sections 15(b)(4)(E) and 15(c) of the Act; Section 17(a) of the Securities Act of 1933; SEC Rules 10b-5 and 15g-1 through 15g-9; NASD Rules 2110, 2120, 2310, 2330, 2440, 3010 (failure to supervise only), 3310, and 3330; MSRB Rules G-19, G-30, and G-37(b) and (c).

Rule G-8: Books and Records to be Made by Brokers, Dealers and Municipal Securities Dealers

(a)(i) – (xiii) No change.

(xiv) *Designation of Persons Responsible for Recordkeeping.* A record of all designations of persons responsible for the maintenance and preservation of books and records as required by rule G-27(b)(ii)(B).

(xv) - (xix) No change.

(xx) *Records Concerning Compliance with Rule G-27.* Each broker, dealer and municipal securities dealer shall maintain the records required under G-27(c), [and G-27](d), (e) and (f).

(xxi) - (xxii) No change.

(b) – (g) No change.

Rule G-9: Preservation of Records

(a) *Records to be Preserved for Six Years.* Every broker, dealer and municipal securities dealer shall preserve the following records for a period of not less than six years:

(i) – (vi) No change.

(vii) the record, described in rule G-27(b)(ii)(B), of each person designated as responsible for supervision of the municipal securities activities of the broker, dealer, or municipal securities dealer and the designated principal's supervisory responsibilities, provided that such record shall be preserved for the period of designation of each person designated and for at least six years following any change in such designation;

(viii) – (x) No change.

(b) – (g) No change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. **Procedures of the Self-Regulatory Organization**

The proposed rule change was adopted by the MSRB at its July 12-13, 2006 meeting. Questions concerning this filing may be directed to Jill C. Finder, Assistant General Counsel, at (703) 797-6600.

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

(a) Over the past two years, NASD and the New York Stock Exchange (“NYSE”) have adopted a series of rule changes designed to strengthen the supervisory control procedures of their member firms. Specifically, NASD amended its Rule 3010 (Supervision) to include more stringent office inspection rules, and adopted new Rule 3012 (Supervisory Control System) to require the testing and verification of a firm’s supervisory procedures.²

MSRB Rule G-27, on supervision, requires brokers, dealers and municipal securities dealers (collectively referred to as “dealers”) to supervise their municipal securities activities by designating individuals with supervisory responsibilities for municipal securities activities, adopting written supervisory procedures, and reviewing transactions and correspondence. Similarly, NASD Rule 3010 requires dealers to establish a supervisory system, adopt written supervisory procedures, review transactions and correspondence, and, most recently, to conduct internal inspections with minimum inspection cycles. NASD also recently adopted new Rule 3012 to require that dealers: (1) test and verify that their supervisory procedures are sufficient, and amend or create additional supervisory procedures where the testing and verification identify a need; and (2) establish procedures that are reasonably designed to review and supervise, on a day-to-day basis, the customer account activity conducted by their producing managers.

In April 2006, the MSRB published for comment draft amendments to Rule G-27, which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically

² See NASD Notice to Members 04-71 (October 2004) (the “2004 NTM”). The NASD and NYSE amendments are substantially similar.

applicable to the municipal securities activities of securities firms and bank dealers.³ The Board received two comment letters in response to the notice, both of which expressed support for the draft amendments, as more fully described below in Section 5.⁴ Based on the comment letters received, as well as discussions with various industry participants and the relevant regulatory agencies, the Board determined to adopt the draft amendments with one substantive revision relating to the designation of appropriate principal. Although the new supervisory activities required under the proposed rule change are derived from NASD requirements, these activities relate specifically to a dealer's municipal securities activities and require in-depth knowledge of MSRB rules. Therefore, the Board believes it is appropriate that these supervisory activities be undertaken by a municipal securities principal (or a municipal fund securities limited principal in the case of activities related to municipal fund securities). The proposed rule change clarifies these requirements by amending the "Appropriate Principal" provision in Rule G-27(b)(ii)(C).⁵

The MSRB believes that adopting most of the requirements of NASD Rules 3010 and 3012 will help ensure a coordinated regulatory approach in the area of supervision, and will facilitate inspection and enforcement.⁶ The proposed amendments to Rule G-27 are described below.

³ MSRB Notice 2006-11 (April 21, 2006).

⁴ Although the notice specifically requested comment from bank dealers, particularly on their ability to comply with the new requirements relating to tape recording of conversations, office inspection, and the new supervisory control provisions, the Board did not receive comment letters from bank dealers. Based on the absence of comment letters from this segment of the industry, as well as informal discussions with the bank regulatory agencies, the Board has no reason to believe that bank dealers will be unable to comply with the new requirements for supervision.

⁵ This provision is also amended to make clear that supervision with respect to correspondence under Rule G-27(e) is to be undertaken by a municipal securities principal (or a municipal fund securities limited principal in the case of correspondence relating to municipal fund securities) or a municipal securities sales principal. Further, subsection (e)(ii) is amended to reflect a recently filed proposed rule change relating to disclosure of fees and expenses in product advertisements and correspondence containing performance data for municipal fund securities, which the Board has requested be made effective on April 1, 2007. *See* SR-MSRB-2006-09 (November 21, 2006).

⁶ The MSRB notes that NASD Rule 3013 (Annual Certification of Compliance and Supervisory Processes) requires NASD member firms to designate a principal to serve as chief compliance officer and to certify, on an annual basis, that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations. This requirement became fully operative on April

Description of Proposed Amendments

The proposed amendments modify section (b) of Rule G-27, on supervisory system; add new subsection (c)(ii), on tape recording of conversations; add new subsection (c)(iii) on updating written supervisory procedures; add new section (d), on internal inspections; add new section (f), on supervisory control system; and add new definitions section (g). As a general principle, the requirements of Rule G-27 apply only with respect to those registered persons who engage in municipal securities activities and those offices in which such municipal securities activities are undertaken (regardless of the level or amount of such municipal securities activities).

Supervisory System

The proposed amendments modify section (b) of Rule G-27, on supervisory system, to include the following five provisions:⁷

- Designation of certain locations as offices of supervisory jurisdiction (“OSJ”) (G-27(b)(iii));
- Designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer (G-27(b)(iv));
- Assignment of each registered person to an appropriately registered representative or principal who shall be responsible for supervising that person’s activities (G-27(b)(v));
- Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities (G-27(b)(vi)); and
- Participation of each registered representative and principal in an annual meeting to discuss compliance matters (G-27(b)(vii)).

1, 2006. Since all NASD member firms are subject to this rule (which requires that firms have supervisory procedures for compliance with MSRB rules), the Board has not incorporated this requirement into amended Rule G-27. Bank dealers, however, are not currently subject to this requirement since they are not NASD members. Therefore, after the Rule G-27 amendments have been in effect for approximately a year, the Board will seek feedback from the bank regulators concerning bank dealers’ ability to comply with the new supervisory requirements over that time period. Assuming there are no compliance problems or concerns in this area, the Board will then consider the propriety of adopting an annual certification requirement for bank dealers.

⁷ These provisions are based on NASD Rule 3010(a)(3)-(7).

The amendments also include a reference in Rule G-27(b)(ii)(C) to “municipal fund securities limited principal” that is added to explicitly affirm the supervisory functions that such a principal may undertake pursuant to Rule G-3, on professional qualifications. Specifically, paragraph (b)(iv)(C) of Rule G-3 allows a municipal fund securities limited principal to “undertake all actions required or permitted under any Board rule to be taken by a municipal securities principal, but solely with respect to activities related to municipal fund securities.”

Tape Recording of Conversations

The amendments incorporate NASD Rule 3010(b)(2), on tape recording of conversations, in Rule G-27(c)(ii). Subsection (c)(ii) requires dealers to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from certain firms that have been expelled or have had their broker/dealer registrations revoked for violations of sales practice rules. The requisite percentage varies depending on the size of the dealer, from 40 percent for a small dealer to 20 percent for a larger dealer. The dealer must establish the required supervisory procedures within 30 days of receiving notice from their registered securities association or bank regulator, or obtaining actual knowledge that it is subject to this provision of the rule.

Under this provision, if the requisite percentage of a dealer’s sales force previously was employed by a disciplined firm, the dealer will be required to adopt special written procedures to supervise the telemarketing activities of all its registered persons. The procedures require, at a minimum, that the dealer tape record all telephone conversations between all of its registered persons and both existing and potential customers for a period of two years. The measures required by this provision are designed to prevent a recurrence of sales practice abuse or other customer harm that caused the disciplined firm to have its registration revoked.

This provision also requires dealers subject to the taping requirement to establish reasonable procedures for reviewing tape recordings to ensure compliance with securities laws and applicable rules and regulations, to retain and catalog the tapes, and to submit reports to the appropriate registered securities association or bank regulator on their supervision of telemarketing.

Updating Written Supervisory Procedures

Subsection (c)(iii) is added to replace existing section (e), which currently requires a dealer to revise and update its written supervisory procedures *as necessary* to respond to changes in Board or other applicable rules. Proposed subsection (c)(iii) has language that mirrors the language in NASD Rule 3010(b)(4), and requires each dealer to keep a copy of procedures at each location where supervisory activities are conducted and to amend its written supervisory procedures within a *reasonable time* after changes occur.

Internal Inspections

The amendments incorporate NASD Rule 3010(c), on internal inspections, in new section (d) under Rule G-27. This new section imposes office inspection requirements that establish minimum inspection cycles and delineate the topics that must be covered during such inspections as well as the manner in which inspections are documented.⁸ In addition, the amendments include new section (g) which defines the designations “office of supervisory jurisdiction” and “branch office” used in section (d), among other terms.

Mandatory Inspection Cycles. Section (d) obligates dealers to inspect OSJs and supervisory branch offices on at least an annual basis.⁹ It also requires dealers to inspect all non-supervisory branch offices at least once every three years. It directs dealers, however, to consider when it might be appropriate to conduct more frequent inspection of non-supervisory branch offices. Further, Rule G-27(d) requires dealers to inspect non-branch locations “on a regular periodic schedule.” Each dealer must document, as part of its written supervisory procedures, an explanation of how the dealer determined the frequency of its examination schedule. In establishing the schedule, dealers should consider the nature and complexity of the securities activities for which each non-branch location is responsible, and the frequency of customer contact at the non-branch location.

Independent Office Inspections. Section (d) places limits on who is eligible to perform the required inspection function. This provision prohibits office inspections from being performed by:

- the branch office manager;
- any person within the office who has supervisory responsibilities; or
- any individual who is directly or indirectly supervised by such person(s).

However, an exception to this limitation is provided if the dealer is so limited in size and resources that it cannot comply with it.

Content of Inspections and Requirements for Inspection Reports. Dealers must document each office inspection by preparing a written report that documents when it conducted the inspection and the results of its testing and verification in the following areas:

⁸ The stringency of the office inspection requirements is graduated and based on designations of offices under specifically defined categories, such as office of supervisory jurisdiction, supervisory and non-supervisory branch offices, and non-branch offices.

⁹ A “branch office” is defined in Rule G-27(g) as “any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding [certain enumerated locations].” A “supervisory branch office” is any non-OSJ branch office that is responsible for supervising one or more non-branch offices.

- Safeguarding customer funds and securities;
- Maintaining books and records;
- Supervising customer accounts services by branch office managers;
- Transmitting funds between customer and registered representative and between customers and third parties;
- Validating customer address changes; *and*
- Validating changes in customer account information.

Heightened Inspection Requirements. Section (d) also requires dealers to adopt, under certain circumstances, procedures that require heightened inspections designed to avoid conflicts of interest arising from economic, commercial or financial interests that the branch manager’s supervisor holds in the person or activities being inspected. Such heightened inspection procedures are required if (1) the person conducting the inspection reports to the branch office manager’s supervisor *or* works in an office supervised by the branch manager’s supervisor; *and* (2) the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager’s supervisor.¹⁰ Dealers must calculate the 20% threshold in the same manner as when determining whether a producing manager must be subject to heightened supervision, as described below.

Supervisory Control System

The amendments also include new section (f), derived from NASD Rule 3012, which incorporates the following new requirements:

Testing and Verification of Supervisory Control Procedures. Section (f) requires dealers to designate and identify one or more principals charged with establishing, maintaining and enforcing a system of “supervisory control policies and procedures” that:

- test and verify that a dealer’s supervisory procedures are reasonably designed to achieve compliance with the federal securities laws and MSRB rules; and
- create additional or amended supervisory procedures where a need for such procedures is identified by such testing.

¹⁰ The 2004 NTM provides examples of such heightened inspection procedures under NASD Rule 3010, including, without limitation, unannounced office inspections; increasing the frequency of inspections; broadening the scope of activities inspected; and/or having one or more principals review or approve the inspection. The MSRB would view these examples as equally applicable to the heightened inspection procedures required under Rule G-27(d)(iii).

Annual Submission of Report to Senior Management. At least once annually, the principal(s) designated under section (f) must submit a report to senior management that details the dealer’s supervisory control policies and procedures, summarizes the results of testing and identifies significant weaknesses, and discusses additional or amended procedures implemented in response to such testing.

The Board recognizes that situations may arise where a dealer is required under the rules of another self-regulatory organization to produce a similar report. The Board does not intend for a dealer to produce duplicative reports in such situations. Instead, for purposes of this section (f), a dealer may prepare a single report so long as there is coordination in the preparation and submission of such report between any principal(s) designated by the dealer pursuant to the rules of another self-regulatory organization and the principal designated under Rule G-27(b)(ii)(C) or (f)(i). The dealer should adequately document such coordination between or among the various principals.

Supervision of Producing Manager’s Customer Account Activity. Section (f) requires dealers to adopt procedures to review and supervise daily customer account activities of each branch office manager, sales manager, regional or district sales manager, or any person performing similar supervisory functions (“producing managers”). These policies and procedures must include “a means of customer confirmation, notification, or follow-up that can be documented.” Specifically, the provision requires that policies and procedures must be reasonably designed to review and monitor the following activities:

- All transmittals of funds and securities to and from customer accounts;
- Changes of customer’s address, including procedures to validate change of address; and
- Changes in customer investment objectives, including validation of such changes.¹¹

Independent Review of Producing Manager. Section (f) requires an independent review of the producing manager. This review must be conducted by a person or persons who are senior to, or “otherwise independent” of, the producing manager. To be considered “otherwise independent” of the producing manager, the person performing the review:

- must not report, either directly or indirectly, to the producing manager he or she is reviewing;
- must be located at a different office than the producing manager;

¹¹ If a dealer does not engage in any of these activities, then the dealer’s supervisory control policies and procedures must note that the dealer is not engaged in these activities and that the supervisory control policies and procedures must be amended before the dealer may engage in such activities.

- must not have supervisory authority over any of the activity under review, including not being *directly* compensated in whole or in part as a result of such activity; *and*
- must alternate such review responsibility with another person at least once every two years.

Section (f) also requires dealers to adopt, under certain circumstances, heightened supervisory procedures designed to avoid conflicts of interest arising from economic, commercial or financial interests that the supervisor holds in the person or activities being supervised. Such heightened supervisory procedures are required with respect to producing managers who are responsible for generating at least 20% of the revenue of the business which is supervised by the producing manager's supervisor.¹² As noted above, the relevant provisions of Rule G-27 would apply if any portion of the 20% threshold is attributable to revenue generated through municipal securities transactions. However, the heightened supervision requirement does not apply where an otherwise independent person conducts the producing manager's reviews.

Finally, section (f) provides an exception from the independent review requirement if a dealer is so limited in size and resources that it is unable to identify anyone who is senior to or otherwise independent of the producing manager to conduct the review (the "limited size and resource" exception).

* * * * *

The MSRB intends generally that the provisions of Rule G-27 be read consistently with the analogous NASD provisions, unless the MSRB specifically indicates otherwise. Thus, relevant NASD interpretations would be presumed to apply to the comparable MSRB provision, subject to the MSRB's right to make distinctions when necessary and appropriate. The MSRB recommends that dealers, including bank dealers, regularly visit or link to the relevant portions of the NASD web site on supervision for current NASD interpretations of such analogous provisions.¹³ Furthermore, the MSRB intends to continue coordinating its requirements relating to supervision with those of the other relevant self-regulatory organizations in the securities markets whenever appropriate for dealers engaging in municipal securities transactions.

¹² The 2004 NTM provides examples of such heightened supervisory procedures under NASD Rule 3012, including, without limitation, unannounced supervisory reviews; increasing the frequency of supervisory reviews by different reviewers within a certain time period; broadening the scope of activities reviewed; and/or having one or more principals approve the supervisory review of such producing manager. The MSRB would view these examples as equally applicable to the heightened supervisory procedures required under Rule G-27(f)(ii)(C).

¹³ NASD's web site on supervision is located at <http://www.nasd.com/RulesRegulation/IssueCenter/SupervisoryControl/index.htm>.

Finally, NASD Rule 3012 (Supervisory Control System) provides that “Any member in compliance with substantially similar requirements of the New York Stock Exchange, Inc. shall be deemed to be in compliance with the provisions of this Rule.” We note that the amendments to Rule G-27 incorporate substantially all of NASD Rule 3012. Therefore, the MSRB believes that any dealer in compliance with similar NASD or NYSE requirements would be deemed in compliance with the comparable requirements of Rule G-27(f), on supervisory control system, so long as there is coordination between or among any principal(s) designated by the dealer pursuant to the rules of NASD or the NYSE and the appropriate principal designated pursuant to Rule G-27(b)(ii)(C).

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

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

The MSRB believes that by conforming Rule G-27 to the relevant NASD rules on supervision and thereby making such requirements specifically applicable to the municipal securities activities of securities firms and bank dealers, the proposed rule change will promote regulatory consistency by facilitating dealer compliance with such requirements, as well as by facilitating the inspection and enforcement thereof.

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

The MSRB does not believe the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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

As discussed above, in April 2006 the MSRB published for comment draft amendments to Rule G-27 which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically applicable to the municipal securities activities of securities firms and bank dealers. In response to its notice, the Board received two comment letters, both of which expressed support for the draft amendments. The Investment Company Institute (“ICI”) noted that conforming MSRB requirements to those of the NASD “will strengthen the current supervisory systems of municipal securities dealers because NASD rules require a more structured and formalized supervisory system than Rule G-27 in its current form.” ICI further stated that the proposal will “facilitate compliance by those dealers that are dually registered with the MSRB and the

NASD...[and that this] conformity should also enable the NASD to more efficiently inspect those dealers that are subject to rules of both self-regulatory organizations.”

The other commentator – BSC Securities – was supportive of the draft amendments but was concerned about “unintended consequences of rulemaking.” BSC noted that, as a small firm, it is particularly concerned with costs of compliance and therefore urged the Board to adopt provisions that are “identical (not ‘substantially similar’) to other SRO’s rules to ensure the coordination of regulatory approaches.” While the Board is sensitive to the costs of compliance, particularly in the case of smaller dealers, we believe that the amendments are appropriate and will result, as ICI stated, in “no substantive difference in the supervisory systems imposed by the rules of the MSRB and the NASD.”

6. Extension of Time Period for SEC Action

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

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

Not applicable.

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

The proposed rule change is based on NASD Rule 3010 (Supervision) and Rule 3012 (Supervisory Control System). The similarities and differences between the proposed rule change and these NASD rules are described in Items 3(a) and 5 above.

9. Exhibits

1. Federal Register Notice
2. Notice requesting comments on draft amendments to Rule G-27 and comment letters

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-MSRB-2006-10)

SELF-REGULATORY ORGANIZATIONS

**Proposed Rule Change by the Municipal Securities Rulemaking Board
Relating to Amendments to Rule G-27, on Supervision, Rule G-8, on
Recordkeeping, and Rule G-9, on Record Retention**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 24, 2006 the Municipal Securities Rulemaking Board (“MSRB” or “Board”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The MSRB is filing with the Commission a proposed rule change consisting of amendments to Rule G-27, on supervision, and the related recordkeeping and record retention requirements of Rules G-8 and G-9. The text of the proposed rule change is available on the MSRB’s web site (<http://www.msrb.org>), at the MSRB’s principal office, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

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

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

1. Purpose

Over the past two years, NASD and the New York Stock Exchange (“NYSE”) have adopted a series of rule changes designed to strengthen the supervisory control procedures of their member firms. Specifically, NASD amended its Rule 3010 (Supervision) to include more stringent office inspection rules, and adopted new Rule 3012 (Supervisory Control System) to require the testing and verification of a firm’s supervisory procedures.³

MSRB Rule G-27, on supervision, requires brokers, dealers and municipal securities dealers (collectively referred to as “dealers”) to supervise their municipal securities activities by designating individuals with supervisory responsibilities for municipal securities activities, adopting written supervisory procedures, and reviewing transactions and correspondence. Similarly, NASD Rule 3010 requires dealers to establish a supervisory system, adopt written supervisory procedures, review transactions

³ The NASD and NYSE amendments are substantially similar.

and correspondence, and, most recently, to conduct internal inspections with minimum inspection cycles. NASD also recently adopted new Rule 3012 to require that dealers: (1) test and verify that its supervisory procedures are sufficient, and amend or create additional supervisory procedures where the testing and verification identify a need; and (2) establish procedures that are reasonably designed to review and supervise, on a day-to-day basis, the customer account activity conducted by the dealer's producing managers.

In April 2006, the MSRB published for comment draft amendments to Rule G-27, which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically applicable to the municipal securities activities of securities firms and bank dealers.⁴ The Board received two comment letters in response to the notice, both of which expressed support for the draft amendments, as more fully described below.⁵ Based on the comment letters received, as well as discussions with various industry participants and the relevant regulatory agencies, the Board determined to adopt the draft amendments with one substantive revision relating to the designation of appropriate principal. Although the new supervisory activities required under the proposed rule change are derived from NASD requirements, these activities relate specifically to a

⁴ MSRB Notice 2006-11 (April 21, 2006).

⁵ Although the notice specifically requested comment from bank dealers, particularly on their ability to comply with the new requirements relating to tape recording of conversations, office inspection, and the new supervisory control provisions, the Board did not receive comment letters from bank dealers. Based on the absence of comment letters from this segment of the industry, as well as informal discussions with the bank regulatory agencies, the Board has no reason to believe that bank dealers will be unable to comply with the new requirements for supervision.

dealer's municipal securities activities and require in-depth knowledge of MSRB rules. Therefore, the Board believes it is appropriate that these supervisory activities be undertaken by a municipal securities principal (or a municipal fund securities limited principal in the case of activities related to municipal fund securities). The proposed rule change clarifies these requirements by amending the "Appropriate Principal" provision in Rule G-27(b)(ii)(C).⁶

The MSRB believes that adopting most of the requirements of NASD Rules 3010 and 3012 will help ensure a coordinated regulatory approach in the area of supervision, and will facilitate inspection and enforcement.⁷ The proposed amendments to Rule G-27 are described below.

Description of Proposed Amendments

⁶ This provision is also amended to make clear that supervision with respect to correspondence under Rule G-27(e) is to be undertaken by a municipal securities principal (or a municipal fund securities limited principal in the case of correspondence relating to municipal fund securities) or a municipal securities sales principal.

⁷ The MSRB notes that NASD Rule 3013 (Annual Certification of Compliance and Supervisory Processes) requires NASD member firms to designate a principal to serve as chief compliance officer and to certify, on an annual basis, that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations. This requirement became fully operative on April 1, 2006. Since all NASD member firms are subject to this rule (which requires that firms have supervisory procedures for compliance with MSRB rules), the Board has not incorporated this requirement into amended Rule G-27. Bank dealers, however, are not currently subject to this requirement since they are not NASD members. Therefore, after the Rule G-27 amendments have been in effect for approximately a year, the Board will seek feedback from the bank regulators concerning bank dealers' ability to comply with the new supervisory requirements over that time period. Assuming there are no compliance problems or concerns in this area, the Board will then consider the propriety of adopting an annual certification requirement for bank dealers.

The proposed amendments modify section (b) of Rule G-27, on supervisory system; add new subsection (c)(ii), on tape recording of conversations; add new subsection (c)(iii) on updating written supervisory procedures; add new section (d), on internal inspections; add new section (f), on supervisory control system; and add new definitions section (g). As a general principle, the requirements of Rule G-27 apply only with respect to those registered persons who engage in municipal securities activities and those offices in which such municipal securities activities are undertaken (regardless of the level or amount of such municipal securities activities).

Supervisory System

The proposed amendments modify section (b) of Rule G-27, on supervisory system, to include the following five provisions:⁸

- Designation of certain locations as offices of supervisory jurisdiction (“OSJ”) (G-27(b)(iii));
- Designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer (G-27(b)(iv));
- Assignment of each registered person to an appropriately registered representative or principal who shall be responsible for supervising that person’s activities (G-27(b)(v));
- Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities (G-27(b)(vi)); and
- Participation of each registered representative and principal in an annual meeting to discuss compliance matters (G-27(b)(vii)).

The amendments also include a reference in Rule G-27(b)(ii)(C) to “municipal fund securities limited principal” that is added to explicitly affirm the supervisory functions

⁸ These provisions are based on NASD Rule 3010(a)(3)-(7).

that such a principal may undertake pursuant to Rule G-3, on professional qualifications. Specifically, paragraph (b)(iv)(C) of Rule G-3 allows a municipal fund securities limited principal to “undertake all actions required or permitted under any Board rule to be taken by a municipal securities principal, but solely with respect to activities related to municipal fund securities.”

Tape Recording of Conversations

The amendments incorporate NASD Rule 3010(b)(2), on tape recording of conversations, in Rule G-27(c)(ii). Subsection (c)(ii) requires dealers to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from certain firms that have been expelled or have had their broker/dealer registrations revoked for violations of sales practice rules. The requisite percentage varies depending on the size of the dealer, from 40 percent for a small dealer to 20 percent for a larger dealer. The dealer must establish the required supervisory procedures within 30 days of receiving notice from their registered securities association or bank regulator, or obtaining actual knowledge that it is subject to this provision of the rule.

Under this provision, if the requisite percentage of a dealer’s sales force previously was employed by a disciplined firm, the dealer will be required to adopt special written procedures to supervise the telemarketing activities of all its registered persons. The procedures require, at a minimum, that the dealer tape record all telephone conversations between all of its registered persons and both existing and potential customers for a period of two years. The measures required by this provision are

designed to prevent a recurrence of sales practice abuse or other customer harm that caused the disciplined firm to have its registration revoked.

This provision also requires dealers subject to the taping requirement to establish reasonable procedures for reviewing tape recordings to ensure compliance with securities laws and applicable rules and regulations, to retain and catalog the tapes, and to submit reports to the appropriate registered securities association or bank regulator on their supervision of telemarketing.

Updating Written Supervisory Procedures

Subsection (c)(iii) is added to replace existing section (e), which currently requires a dealer to revise and update its written supervisory procedures *as necessary* to respond to changes in Board or other applicable rules. Proposed subsection (c)(iii) has language that mirrors the language in NASD Rule 3010(b)(4), and requires each dealer to keep a copy of procedures at each location where supervisory activities are conducted and to amend its written supervisory procedures within a *reasonable time* after changes occur.

Internal Inspections

The amendments incorporate NASD Rule 3010(c), on internal inspections, in new section (d) under Rule G-27. This new section imposes office inspection requirements that establish minimum inspection cycles and delineate the topics that must be covered during such inspections as well as the manner in which inspections are documented.⁹ In

⁹ The stringency of the office inspection requirements is graduated and based on designations of offices under specifically defined categories, such as office of

addition, the amendments include new section (g) which defines the designations “office of supervisory jurisdiction” and “branch office” used in section (d), among other terms.

Mandatory Inspection Cycles. Section (d) obligates dealers to inspect OSJs and supervisory branch offices on at least an annual basis.¹⁰ It also requires dealers to inspect all non-supervisory branch offices at least once every three years. It directs dealers, however, to consider when it might be appropriate to conduct more frequent inspection of non-supervisory branch offices. Further, Rule G-27(d) requires dealers to inspect non-branch locations “on a regular periodic schedule.” Each dealer must document, as part of its written supervisory procedures, an explanation of how the dealer determined the frequency of its examination schedule. In establishing the schedule, dealers should consider the nature and complexity of the securities activities for which each non-branch location is responsible, and the frequency of customer contact at the non-branch location.

Independent Office Inspections. Section (d) places limits on who is eligible to perform the required inspection function. This provision prohibits office inspections from being performed by:

- the branch office manager;
- any person within the office who has supervisory responsibilities; or

supervisory jurisdiction, supervisory and non-supervisory branch offices, and non-branch offices.

¹⁰ A “branch office” is defined in Rule G-27(g) as “any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding [certain enumerated locations].” A “supervisory branch office” is any non-OSJ branch office that is responsible for supervising one or more non-branch offices.

- any individual who is directly or indirectly supervised by such person(s).

However, an exception to this limitation is provided if the dealer is so limited in size and resources that it cannot comply with it.

Content of Inspections and Requirements for Inspection Reports. Dealers must document each office inspection by preparing a written report that documents when it conducted the inspection and the results of its testing and verification in the following areas:

- Safeguarding customer funds and securities;
- Maintaining books and records;
- Supervising customer accounts services by branch office managers;
- Transmitting funds between customer and registered representative and between customers and third parties;
- Validating customer address changes; *and*
- Validating changes in customer account information.

Heightened Inspection Requirements. Section (d) also requires dealers to adopt, under certain circumstances, procedures that require heightened inspections designed to avoid conflicts of interest arising from economic, commercial or financial interests that the branch manager's supervisor holds in the person or activities being inspected. Such heightened inspection procedures are required if (1) the person conducting the inspection reports to the branch office manager's supervisor *or* works in an office supervised by the branch manager's supervisor; *and* (2) the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor.¹¹ Dealers must calculate the 20% threshold in the

¹¹ The 2004 NTM provides examples of such heightened inspection procedures under NASD Rule 3010, including, without limitation, unannounced office

same manner as when determining whether a producing manager must be subject to heightened supervision, as described below.

Supervisory Control System

The amendments also include new section (f), derived from NASD Rule 3012, which incorporates the following new requirements:

Testing and Verification of Supervisory Control Procedures. Section (f) requires dealers to designate and identify one or more principals charged with establishing, maintaining and enforcing a system of “supervisory control policies and procedures” that:

- test and verify that a dealer’s supervisory procedures are reasonably designed to achieve compliance with the federal securities laws and MSRB rules; and
- create additional or amended supervisory procedures where a need for such procedures is identified by such testing.

Annual Submission of Report to Senior Management. At least once annually, the principal(s) designated under section (f) must submit a report to senior management that details the dealer’s supervisory control policies and procedures, summarizes the results of testing and identifies significant weaknesses, and discusses additional or amended procedures implemented in response to such testing.

inspections; increasing the frequency of inspections; broadening the scope of activities inspected; and/or having one or more principals review or approve the inspection. The MSRB would view these examples as equally applicable to the heightened inspection procedures required under Rule G-27(d)(iii).

The Board recognizes that situations may arise where a dealer is required under the rules of another self-regulatory organization to produce a similar report. The Board does not intend for a dealer to produce duplicative reports in such situations. Instead, for purposes of this section (f), a dealer may prepare a single report so long as there is coordination in the preparation and submission of such report between any principal(s) designated by the dealer pursuant to the rules of another self-regulatory organization and the principal designated under Rule G-27(b)(ii)(C) or (f)(i). The dealer should adequately document such coordination between or among the various principals.

Supervision of Producing Manager’s Customer Account Activity. Section (f) requires dealers to adopt procedures to review and supervise daily customer account activities of each branch office manager, sales manager, regional or district sales manager, or any person performing similar supervisory functions (“producing managers”). These policies and procedures must include “a means of customer confirmation, notification, or follow-up that can be documented.” Specifically, the provision requires that policies and procedures must be reasonably designed to review and monitor the following activities:

- All transmittals of funds and securities to and from customer accounts;
- Changes of customer’s address, including procedures to validate change of address; and
- Changes in customer investment objectives, including validation of such changes.¹²

¹² If a dealer does not engage in any of these activities, then the dealer’s supervisory control policies and procedures must note that the dealer is not engaged in these activities and that the supervisory control policies and procedures must be amended before the dealer may engage in such activities.

Independent Review of Producing Manager. Section (f) requires an independent review of the producing manager. This review must be conducted by a person or persons who are senior to, or “otherwise independent” of, the producing manager. To be considered “otherwise independent” of the producing manager, the person performing the review:

- must not report, either directly or indirectly, to the producing manager he or she is reviewing;
- must be located at a different office than the producing manager;
- must not have supervisory authority over any of the activity under review, including not being *directly* compensated in whole or in part as a result of such activity; *and*
- must alternate such review responsibility with another person at least once every two years.

Section (f) also requires dealers to adopt, under certain circumstances, heightened supervisory procedures designed to avoid conflicts of interest arising from economic, commercial or financial interests that the supervisor holds in the person or activities being supervised. Such heightened supervisory procedures are required with respect to producing managers who are responsible for generating at least 20% of the revenue of the business which is supervised by the producing manager’s supervisor.¹³ As noted above, the relevant provisions of Rule G-27 would apply if any portion of the 20% threshold is attributable to revenue generated through municipal securities transactions. However, the

¹³ The 2004 NTM provides examples of such heightened supervisory procedures under NASD Rule 3012, including, without limitation, unannounced supervisory reviews; increasing the frequency of supervisory reviews by different reviewers within a certain time period; broadening the scope of activities reviewed; and/or having one or more principals approve the supervisory review of such producing manager. The MSRB would view these examples as equally applicable to the heightened supervisory procedures required under Rule G-27(f)(ii)(C).

heightened supervision requirement does not apply where an otherwise independent person conducts the producing manager's reviews.

Finally, section (f) provides an exception from the independent review requirement if a dealer is so limited in size and resources that it is unable to identify anyone who is senior to or otherwise independent of the producing manager to conduct the review (the "limited size and resource" exception).

* * * * *

The MSRB intends generally that the provisions of Rule G-27 be read consistently with the analogous NASD provisions, unless the MSRB specifically indicates otherwise. Thus, relevant NASD interpretations would be presumed to apply to the comparable MSRB provision, subject to the MSRB's right to make distinctions when necessary and appropriate. The MSRB recommends that dealers, including bank dealers, regularly visit or link to the relevant portions of the NASD web site on supervision for current NASD interpretations of such analogous provisions.¹⁴ Furthermore, the MSRB intends to continue coordinating its requirements relating to supervision with those of the other relevant self-regulatory organizations in the securities markets whenever appropriate for dealers engaging in municipal securities transactions.

Finally, NASD Rule 3012 (Supervisory Control System) provides that "Any member in compliance with substantially similar requirements of the New York Stock Exchange, Inc. shall be deemed to be in compliance with the provisions of this Rule."

¹⁴ NASD's web site on supervision is located at <http://www.nasd.com/RulesRegulation/IssueCenter/SupervisoryControl/index.htm>.

We note that the amendments to Rule G-27 incorporate substantially all of NASD Rule 3012. Therefore, the MSRB believes that any dealer in compliance with similar NASD or NYSE requirements would be deemed in compliance with the comparable requirements of Rule G-27(f), on supervisory control system, so long as there is coordination between or among any principal(s) designated by the dealer pursuant to the rules of NASD or the NYSE and the appropriate principal designated pursuant to Rule G-27(b)(ii)(C).

2. Statutory Basis

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

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

The MSRB believes that by conforming Rule G-27 to the relevant NASD rules on supervision and thereby making such requirements specifically applicable to the municipal securities activities of securities firms and bank dealers, the proposed rule change will promote regulatory consistency by facilitating dealer compliance with such requirements, as well as by facilitating the inspection and enforcement thereof.

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

The MSRB does not believe that the proposed rule change will result in any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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

In April 2006 the MSRB published for comment draft amendments to Rule G-27 which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically applicable to the municipal securities activities of securities firms and bank dealers. In response to its notice, the Board received two comment letters, both of which expressed support for the draft amendments. The Investment Company Institute (“ICI”) noted that conforming MSRB requirements to those of the NASD “will strengthen the current supervisory systems of municipal securities dealers because NASD rules require a more structured and formalized supervisory system than Rule G-27 in its current form.” ICI further stated that the proposal will “facilitate compliance by those dealers that are dually registered with the MSRB and the NASD...[and that this] conformity should also enable the NASD to more efficiently inspect those dealers that are subject to rules of both self-regulatory organizations.”

The other commentator – BSC Securities – was supportive of the draft amendments but was concerned about “unintended consequences of rulemaking.” BSC noted that, as a small firm, it is particularly concerned with costs of compliance and therefore urged the Board to adopt provisions that are “identical (not ‘substantially similar’) to other SRO’s rules to ensure the coordination of regulatory approaches.” While the Board is sensitive to the costs of compliance, particularly in the case of smaller dealers, we believe that the amendments are appropriate and will result, as ICI stated, in

“no substantive difference in the supervisory systems imposed by the rules of the MSRB and the NASD.”

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

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

- (A) by order approve the proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

The MSRB has proposed that the amendments become effective six months after Commission approval of the proposed rule change.

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>);
or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2006-10 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, N.E., Washington, DC 20549-1090.

All submissions should refer to File Number SR-MSRB-2006-10. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, N.E., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2006-10 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority (17 CFR 200.30-3(a)(12)).

Nancy M. Morris
Secretary



MSRB NOTICE 2006-11 (APRIL 21, 2006)

REQUEST FOR COMMENTS ON DRAFT AMENDMENTS TO RULE G-27, ON SUPERVISION, THAT STRENGTHEN SUPERVISORY PROCEDURES

[Home Page](#) | [Back](#)

Introduction

Over the past two years, a series of NASD and New York Stock Exchange ("NYSE") rule changes were put into effect that are designed to strengthen the supervisory control procedures of dealer firms.[1] Specifically, NASD amended Rule 3010 (Supervision) to include more stringent office inspection rules, and added new Rule 3012 (Supervisory Control System), which requires the testing and verification of a firm's supervisory procedures.

The Municipal Securities Rulemaking Board ("MSRB") has approved releasing this notice seeking comment on draft amendments adopting substantially similar rule changes. The MSRB believes that conforming its rule language to the language in the NASD rules will help ensure a coordinated regulatory approach in the area of supervision and facilitate inspection and enforcement. The draft amendments are described more fully below.

Background

Rule G-27, on supervision, places an obligation on a dealer to supervise its municipal securities activities. It requires a dealer to accomplish this objective by designating individuals with supervisory responsibilities for municipal securities activities, adopting written supervisory procedures, and reviewing transactions and correspondence. Similarly, NASD Rule 3010 obligates a dealer to establish a supervisory system, requires written supervisory procedures and the review of transactions and correspondence, and most recently, requires internal inspections with minimum inspection cycles.

The NASD also recently adopted new Rule 3012, which requires dealers to do two things: (1) a dealer must test and verify that its supervisory procedures are sufficient and amend or create additional supervisory procedures where the testing and verification identify a need; and (2) a dealer must have procedures that are reasonably designed to review and supervise on a day-to-day basis the customer account activity conducted by the dealer's producing managers.

The MSRB believes that adopting most of the requirements of NASD Rules 3010 and 3012 promotes regulatory consistency while making these requirements specifically applicable to transactions in municipal securities by securities firms and bank dealers. The following is a description of the draft amendments to Rule G-27.

Description of Draft Amendments

The draft amendments modify section (b) of Rule G-27, on supervisory system; add new section (c)(ii), on tape recording of conversations; add (c)(iii) on updating written supervisory procedures; add new section (d), on internal inspections; and add new section (f), on supervisory control system.

Supervisory System

The draft amendments modify section (b) of Rule G-27, on supervisory system, to include the following five provisions:[2]

- Designation of certain locations as offices of supervisory jurisdiction ("OSJ")[3] (G-27(b)(iii));
- Designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer (G-27(b)(iv));
- Assignment of each registered person to an appropriately registered representative or principal who shall be responsible for supervising that person's activities (G-27(b)(v));
- Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities (G-27(b)(vi)); and
- Participation of each registered representative and principal in an annual meeting to discuss compliance matters (G-27(b)(vii)).

The draft amendments also include a reference to "municipal fund securities limited principal" that is added to explicitly affirm the supervisory functions that such a principal may undertake pursuant to Rule G-3, on professional qualifications. Specifically, subsection (b)(iv)(C) of Rule G-3 allows a municipal fund securities limited principal to "undertake all actions required or permitted under any Board rule to be taken by a municipal securities principal, but solely with respect to activities related to municipal fund securities."

Tape Recording of Conversations

The draft amendments incorporate NASD Rule 3010(b)(2), on tape recording of conversations, in new provision G-27(c)(ii). Section (c)(ii) requires dealers to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from certain firms that have been expelled or have had their broker/dealer registrations revoked for violations of sales practice rules.[4] The requisite percentage varies depending on the size of the dealer, from 40 percent for a small dealer to 20 percent for a larger dealer. The dealer must establish the required supervisory procedures within 30 days of receiving notice from their registered securities association or bank regulator, or obtaining actual knowledge that it is subject to this provision of the rule.

Under this provision, if the requisite percentage of a dealer's sales force previously was employed by a disciplined firm, the dealer will be required to adopt special written procedures to supervise the telemarketing activities of all its registered persons. The procedures require, at a minimum, that the dealer tape records all telephone conversations between all of its registered persons and both existing and potential customers for a period of two years. The measures required by this provision are designed to prevent a recurrence of sales practice abuse or other customer harm that caused the disciplined firm to have its registration revoked.

This provision also requires dealers subject to the taping requirement to establish reasonable procedures for reviewing tape recordings to ensure compliance with securities laws and applicable rules and regulations, to retain and catalog the tapes, and to submit reports to the appropriate registered securities association or bank regulator on their supervision of telemarketing.

Updating Written Supervisory Procedures

Subsection (c)(iii) is added to replace current section (e) which currently requires a dealer to revise and update its written supervisory procedures *as necessary* to respond to changes in Board or other applicable rules. Draft subsection (c)(iii) has language that mirrors the language

in NASD Rule 3010(b)(4), and requires each dealer to keep a copy of procedures at each location where supervisory activities are conducted and to amend its written supervisory procedures within a *reasonable time* after changes occur.

Internal Inspections

The draft amendments incorporate NASD Rule 3010(c), on internal inspections, in new section G-27(d). This new section imposes office inspection requirements that establish minimum inspection cycles and delineate the topics that must be covered during such inspections as well as the manner in which inspections are documented.[5] In addition, the draft amendments include new section G-27(g) which defines the designations "office of supervisory jurisdiction" and "branch office" used in section (d), among other terms.

Mandatory Inspection Cycles. Section (d) obligates dealers to inspect OSJs and supervisory branch offices[6] on at least an annual basis. It also requires dealers to inspect all non-supervisory branch offices at least once every three years. It directs dealers, however, to consider when it might be appropriate to conduct more frequent inspection of non-supervisory branch offices. Further, G-27(d) requires dealers to inspect non-branch locations "on a regular periodic schedule." Each dealer must document, as part of its written supervisory procedures, an explanation of how the dealer determined the frequency of its examination schedule. In establishing the schedule, dealers should consider the nature and complexity of the securities activities for which each non-branch location is responsible, and the frequency of customer contact at the non-branch location.

Independent Office Inspections. Section (d) places limits on who is eligible to perform the required inspection function. This provision prohibits office inspections from being performed by:

- the branch office manager;
- any person within the office who has supervisory responsibilities; or
- any individual who is directly or indirectly supervised by such person(s).

However, an exception to this limitation is provided if the dealer is so limited in size and resources that it cannot comply with it.

Content of Inspections and Requirements for Inspection Reports. Dealers must document each office inspection by preparing a written report that documents when it conducted the inspection and the results of its testing and verification in the following areas:

- Safeguarding customer funds and securities;
- Maintaining books and records;
- Supervising customer accounts services by branch office managers;
- Transmitting funds between customer and registered representative and between customers and third parties;
- Validating customer address changes; *and*
- Validating changes in customer account information.

Heightened Inspection Requirements. Section (d) also requires dealers to adopt procedures that require heightened inspection if (1) the person conducting the inspection reports to the branch office manager's supervisor *or* works in an office supervised by the branch manager's supervisor; *and* (2) the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. Dealers must calculate the 20% threshold in the same manner as when determining whether a producing manager must be subject to heightened supervision. Examples of such "heightened" inspection procedure may include, without limitations, the following:

- unannounced office inspections;

- increasing the frequency of inspections;
- broadening the scope of activities inspected; and
- having one or more principals review or approve the inspection.

Supervisory Control System

The draft amendments also include a new section derived from NASD Rule 3012. Section (f) of the draft amendments incorporates the following new requirements:

Testing and Verification of Supervisory Control Procedures. Section (f) requires dealers to designate and identify one or more principals charged with establishing, maintaining and enforcing a system of "supervisory control policies and procedures" that:

- test and verify that a dealer's supervisory procedures are reasonably designed to achieve compliance with the federal securities laws and MSRB rules; and
- create additional or amended supervisory procedures where a need for such procedures is identified by such testing.

Annual Submission of Report to Senior Management. At least once annually, the principal(s) designated under section (f) must submit a report to senior management that details the dealer's supervisory control policies and procedures, summarizes the results of testing and identifies significant weaknesses, and discusses additional or amended procedures implemented in response to such testing.

Supervision of Producing Manager's Customer Account Activity. Section (f) requires dealers to adopt procedures to review and supervise daily customer account activities of each branch office manager, sales manager, regional or district sales manager, or any person performing similar supervisory functions ("producing managers"). These policies and procedures must include "a means of customer confirmation, notification, or follow-up that can be documented." Specifically, the draft provision requires that policies and procedures must be reasonably designed to review and monitor the following activities:

- All transmittals of funds and securities to and from customer accounts;
- Changes of customer's address, including procedures to validate change of address; and
- Changes in customer investment objectives, including validation of such changes.[7]

Independent Review of Producing Manager. Section (f) requires an independent review of the producing manager. This review must be conducted by a person or persons who are senior to, or "otherwise independent" of, the producing manager. To be considered "otherwise independent" of the producing manager, the person performing the review:

- must not report, either directly or indirectly, to the producing manager he or she is reviewing;
- must be located at a different office than the producing manager;
- must not have supervisory authority over any of the activity under review, including not being *directly* compensated in whole or in part as a result of such activity; *and*
- must alternate such review responsibility with another person at least once every two years.

Section (f) also requires enhanced supervision of producing managers who are responsible for generating at least 20% of the revenue of the business which is supervised by the producing manager's supervisor. Examples of "heightened" supervisory procedures may include the following:[8]

- unannounced supervisory reviews;
- increasing the frequency of supervisory reviews by different reviewers within a certain time period;
- broadening the scope of activities reviewed; and
- having one or more principals approve the supervisory review of such producing manager.

The heightened supervision requirement does not apply where an otherwise independent person conducts the producing manager's reviews.

Finally, section (f) provides an exception from the independent review requirement if a dealer is so limited in size and resources that it is unable to identify anyone who is senior to or otherwise independent of the producing manager to conduct the review ("limited size and resource" exception).

* * * * *

The MSRB intends generally that the provisions of Rule G-27 be read consistently with the analogous NASD provisions, unless the MSRB specifically indicates otherwise. Thus, relevant NASD interpretations would be presumed to apply to the comparable MSRB provision, subject to the MSRB's right to make distinctions when necessary and appropriate. Furthermore, the MSRB intends to continue coordinating its requirements relating to supervision with those of the other relevant self-regulatory organizations in the securities markets.

Request for Comment

The MSRB seeks comments on all aspects of the draft amendments. Although NASD member firms have been subject to the requirements proposed in the draft amendments through the application of NASD Rules 3010 and 3012 to their securities activities, bank dealers have not been subject to these new requirements. Thus, the MSRB is interested in receiving comments from bank dealers, particularly on their ability to comply with the tape recording of conversation requirements of section (c)(2), the new office inspection requirements of section (d), and the new supervisory control provisions in section (f) of the draft amendments.

* * * * *

Comments should be submitted no later than June 8, 2006, and may be directed to Ghassan Hitti, Assistant General Counsel. Written comments will be available for public inspection.

April 21, 2006

* * * * *

Text of Draft Amendments [9]

Rule G-27. (a) *Obligation to supervise.* Each broker, dealer and municipal securities dealer ("dealer") shall supervise the conduct of the municipal securities activities of the dealer and its associated persons to ensure compliance with Board rules and the applicable provisions of the Act and rules thereunder ("applicable rules").

[(b) *Designation of principals.*

(i) *General.* Each dealer shall specifically designate one or more associated persons qualified as municipal securities principals, municipal securities sales principals, financial and operations principals in accordance with Board rules, or as general securities principals to be responsible for the supervision of the municipal securities activities of the dealer and its associated persons as required by this rule.

(ii) *Written Record.* A written record of each supervisory designation and of the designated principal's responsibilities under this rule shall be maintained and updated as required under rule G-9.

(iii) *Appropriate principal.* Each dealer shall designate a municipal securities principal as responsible for its supervision under sections (a) and (c) of this rule, except as provided in this section. A non-bank dealer shall designate a financial and operations

principal as responsible for the financial reporting duties specified in rule G-3(d)(i)(A-E) and with primary responsibility for books and records under section (c)(v) below; provided, however, that a non-bank dealer meeting the requirements of Securities Exchange Act rule 15c3-1(a)(2)(iv), (v) or (vi) or the exemption under rule 15c3-1(b)(3) may, but is not required to, designate a financial and operations principal as responsible for such financial reporting duties and with primary responsibility for such books and records. In addition, a municipal securities sales principal may be designated as responsible for supervision under sections (c)(ii), (iii) and (vii) of this rule, to the extent the activities pertain to sales to or purchases from a customer; a general securities principal may be designated as responsible for supervision under sections (c)(v) and (vii)(A) of this rule and under rules G-7(b) and G-21(e); and a financial and operations principal may be designated as responsible for supervision under section (c)(vi) of this rule.]

(b) Supervisory System. Each dealer shall establish and maintain a system to supervise the municipal securities activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable Board rules. Final responsibility for proper supervision shall rest with the dealer. A dealer's supervisory system shall provide, at a minimum, for the following:

(i) The establishment and maintenance of written procedures as required by sections (c), (d), (e) and (f) of this rule.

(ii) (A) General. The designation of one or more associated persons qualified as municipal securities principals, municipal securities sales principals, municipal fund securities limited principals, financial and operations principals in accordance with Board rules, or as general securities principals to be responsible for the supervision of the municipal securities activities of the dealer and its associated persons as required by this rule.

(B) Written Record. A written record of each supervisory designation and of the designated principal's responsibilities under this rule shall be maintained and updated as required under Rule G-9.

(C) Appropriate Principal. Each dealer shall designate a municipal securities principal as responsible for its supervision under sections (a) and (c) of this rule, except as provided in this section. A non-bank dealer shall designate a financial and operations principal as responsible for the financial reporting duties specified in Rule G-3(d)(i)(A-E) and with primary responsibility for books and records under section (c)(i)(E) below; provided, however, that a non-bank dealer meeting the requirements of Securities Exchange Act rule 15c3-1(a)(2)(iv), (v) or (vi) or the exemption under rule 15c3-1(b)(3) may, but is not required to, designate a financial and operations principal as responsible for such financial reporting duties and with primary responsibility for such books and records. In addition, a municipal securities sales principal may be designated as responsible for supervision under sections (c)(i)(B), (C) and (G) of this rule, to the extent the activities pertain to sales to or purchases from a customer; a general securities principal may be designated as responsible for supervision under sections (c)(i)(E) and (G)(1) of this rule and under Rules G-7(b) and G-21(e); and a financial and operations principal may be designated as responsible for supervision under section (c)(i)(F) of this rule. A municipal fund securities limited principal may be designated as responsible for supervision under sections (a) and (c) of this rule to the extent that the activities pertain solely to

transactions in municipal fund securities.

(iii) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (g) of this rule. Each dealer shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives, registered principals, and other associated persons in accordance with the standards set forth in this rule, taking into consideration the following factors:

(A) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(C) whether the location is geographically distant from another OSJ of the dealer;

(D) whether the dealer's registered persons are geographically dispersed; and

(E) whether the securities activities at such location are diverse and/or complex.

(iv) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer.

(v) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(vi) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(vii) The participation of each registered representative and registered principal, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the dealer at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's(') or principal's(') place of business.

(c) Written supervisory procedures.

(i) Each dealer shall adopt, maintain and enforce written supervisory procedures reasonably designed to ensure that the conduct of the municipal securities activities of the dealer and its associated persons are in compliance as required in section (a) of this rule. Such procedures shall codify the dealer's supervisory system for ensuring compliance and, at a minimum, shall establish procedures

[(i)] (A) that state how a designated principal shall monitor for compliance by the dealer with all applicable rules and supervise the activities of associated persons specified in rule G-3(a)(i);

[(ii)] (B) a designated principal shall follow when a customer complaint concerning the dealer's municipal securities activities is received;

[(iii)] (C) 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; such review shall be designed to ensure that such transactions are in accordance with all applicable rules and to detect and prevent irregularities and abuses;

[(iv)] (D) for the periodic review by a designated principal of each office which engages in municipal securities activities pursuant to section (d) of this rule;

[(v)] (E) for the maintenance and preservation, by a designated principal, of the books and records required to be maintained and preserved by rules G-8 and G-9 of the Board;

[(vi)] (F) for the supervision by a designated principal of the processing, clearance, and in the case of a non-bank dealer safekeeping of municipal securities; and

[(vii)] (G) for the prompt review and written approval by a designated principal of:

[(A)] (1) the opening of each customer account introduced or carried by the dealer in which transactions in municipal securities may be effected; and

[(B)] (2) each transaction in municipal securities on a daily basis, including each transaction in municipal securities effected with or for a discretionary account introduced or carried by the dealer.

(ii) Tape recording of conversations

(A) Each dealer that either is notified by the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, or otherwise has actual knowledge that it meets one of the criteria in paragraph (c)(ii)(H) relating to the employment history of its registered persons at a disciplined firm as defined in paragraph (c)(ii)(J) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B) The dealer must establish and implement the supervisory procedures required by this paragraph within 60 days of receiving notice from the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, or obtaining actual knowledge that it is subject to the provisions of this paragraph.

A dealer that meets one of the criteria in paragraph (c)(ii)(H) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice from the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, pursuant to the provisions of paragraph (c)(ii)(A) or obtaining actual knowledge that it is subject to the provisions of the paragraph, provided the dealer promptly notifies the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, in writing of its becoming subject to the Rule. Once the dealer has reduced its staffing levels to fall below the threshold levels, it shall not rehire a

person terminated to accomplish the staff reduction for a period of 180 days. On or prior to reducing staffing levels pursuant to this paragraph, a dealer must provide the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, with written notice, identifying the terminated person(s).

(C) The procedures required by this paragraph shall include tape-recording all telephone conversations between the dealer's registered persons and both existing and potential customers.

(D) The dealer shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules. The procedures must be appropriate for the dealer's business, size, structure, and customers.

(E) All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each dealer shall catalog the retained tapes by registered person and date.

(F) Such procedures shall be maintained for a period of three years from the date that the dealer establishes and implements the procedures required by the provisions of this paragraph.

(G) By the 30th day of the month following the end of each calendar quarter, each dealer subject to the requirements of this paragraph shall submit to the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, a report on the dealer's supervision of the telemarketing activities of its registered persons.

(H) The following dealers shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

(1) A dealer with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

(2) A dealer with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

(3) A dealer with at least twenty registered persons, where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years.

(4) For purposes of the calculations required in subparagraph (H), dealers should not include registered persons who:

(a) have been registered for an aggregate total of 90 days or less with one or more disciplined

firms within the past three years; and

(b) do not have a disciplinary history.

(I) For purposes of this rule, the term "registered person" means any person registered pursuant to Rule G-3.

(J) For purposes of this rule, the term "disciplined firm" means either a dealer that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer; or a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the Securities and Exchange Commission revoking its registration as a broker or dealer.

(K) For purposes of this rule, the term "disciplinary history" means a finding of a violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the following rules: Sections 15(b)(4)(E) and 15(c) of the Act; Section 17(a) of the Securities Act of 1933; SEC Rules 10b-5 and 15g-1 through 15g-9; NASD Rules 2110, 2120, 2310, 2330, 2440, 3010 (failure to supervise only), 3310, and 3330; MSRB Rules G-19, G-30, or G-37(b) or (c), or comparable foreign provisions.

(L) A registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, upon application, may in exceptional circumstances, taking into consideration all relevant factors, exempt such dealer unconditionally or on specified terms and conditions from the requirements of this paragraph. In the case of dealers that are NASD members, the NASD may exempt such dealer member unconditionally or on specified terms and conditions from the requirements of this paragraph pursuant to the NASD Rule 9600 Series. A dealer seeking an exemption must file a written application within 30 days after receiving notice from the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer, or obtaining actual knowledge that it meets one of the criteria in paragraph (c)(ii)(H). A dealer that meets one of the criteria in paragraph (c)(ii)(H) for the first time may elect to reduce its staffing levels pursuant to the provisions of paragraph (c)(ii)(B) or, alternatively, to seek an exemption pursuant to paragraph (c)(ii)(L), as appropriate; such a dealer may not seek relief from the Rule by both reducing its staffing levels pursuant to paragraph (c)(ii)(B) and requesting an exemption.

(iii) A copy of a dealer's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the dealer. Each dealer shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in Board or other applicable rules and as changes occur in its supervisory system, and each dealer shall be responsible for communicating amendments through its organization.

(d) Internal Inspections

(i) Each dealer shall conduct a review, at least annually, of the municipal securities activities in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable Board rules. Each dealer shall review the municipal securities activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.

(A) Each dealer shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.

(B) Each dealer shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the dealer shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a dealer establishes a more frequent inspection cycle, the dealer must ensure that at least every three years, the inspection requirements enumerated in paragraph (d)(ii) have been met. The non-supervisory branch office examination cycle, an explanation of the factors the dealer used in determining the frequency of the examinations in the cycle, and the manner in which a dealer will comply with paragraph (d)(ii) if using more frequent inspections than every three years shall be set forth in the dealer's written supervisory and inspection procedures.

(C) Each dealer shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the dealer shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the dealer determined the frequency of the examination schedule shall be set forth in the dealer's written supervisory and inspection procedures.

Each dealer shall retain a written record of the dates upon which each review and inspection is conducted.

(ii) An office inspection and review by a dealer pursuant to paragraph (d)(i) must be reduced to a written report and kept on file by the dealer for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (d)(i)(C) and the regular periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and

verification of the dealer's policies and procedures, including supervisory policies and procedures in the following areas:

- (A) Safeguarding of customer funds and securities;
- (B) Maintaining books and records;
- (C) Supervision of customer accounts serviced by branch office managers;
- (D) Transmittal of funds between customers and registered representatives and between customers and third parties;
- (E) Validation of customer address changes; and
- (F) Validation of changes in customer account information.

If a dealer does not engage in all of the activities enumerated above, the dealer must identify those activities in which it does not engage in the written inspection report and document in the report that supervisory policies and procedures for such activities must be in place before the dealer can engage in them.

(iii) An office inspection by a dealer pursuant to paragraph (d)(i) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). However, if a dealer is so limited in size and resources that it cannot comply with this limitation (e.g., a dealer with only one office or a dealer has a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the dealer may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The dealer, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.

A dealer must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a dealer's internal allocation of such revenue. A dealer must calculate the 20% threshold on a rolling, twelve-month basis.

[(d)] (e) *Review of Correspondence*

(i) Supervision of Municipal Securities Representatives. Each dealer shall establish procedures for the review by a designated principal of incoming and outgoing written (i.e., non-electronic) and electronic correspondence of its municipal securities representatives with the public relating to the municipal securities activities of such dealer. Such procedures must be in writing and be designed to reasonably supervise

each municipal securities representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available, upon request, to a registered securities association or the appropriate regulatory agency [as defined in section 3(a)(34) of the Act].

(ii)- No Change.

(iii) Retention of correspondence. Each dealer shall retain correspondence of municipal securities representatives relating to its municipal securities activities in accordance with rules G-8(a)(xx) and G-9(b)(viii) and (xiv). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available, upon request, to a registered securities association or the appropriate regulatory agency [as defined in Section 3(a)(34) of the Act].

[(e) Duty to update and review written procedures. Each dealer shall revise and update its written supervisory procedures as necessary to respond to changes in Board or other applicable rules and as other circumstances require. In addition, each dealer shall review, at least on an annual basis, its supervisory system and written supervisory procedures adopted under sections (c) and (d) of this rule to determine whether they are adequate and up-to-date and shall ensure that the dealer is in compliance with this rule.]

(f) Supervisory Control System

(i) Each dealer shall designate one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the dealer's supervisory procedures are reasonably designed with respect to the municipal securities activities of the dealer and its registered representatives and associated persons, to achieve compliance with applicable rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the dealer's senior management no less than annually a report detailing each dealer's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

(ii) The establishment, maintenance, and enforcement of written supervisory control policies and procedures pursuant to paragraph (f)(i) shall include:

(A) procedures that are reasonably designed to review and supervise the customer account activity conducted by the dealer's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

(1) General Supervisory Requirement. A person who is either senior to, or otherwise independent of, the producing manager must perform such supervisory reviews. For purposes of this rule, an "otherwise independent" person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less.

(2) "Limited Size and Resources" Exception. If a dealer is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to (1) above (e.g., a dealer has only one office or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a principal who is sufficiently knowledgeable of the dealer's supervisory control procedures, provided that the reviews are in compliance with (1) to the extent practicable.

(3) Notification Requirement. If a dealer determines that it must rely on the "limited size and resources" exception set forth in (2) above to conduct any of its producing managers' supervisory reviews, the dealer must notify the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer through an electronic process (or any other process prescribed by such association or agency) within 30 days of the date on which the dealer first relies on the exception, and annually thereafter. If a dealer subsequently determines that it no longer needs to rely on the exception to conduct any of its producing managers' supervisory reviews, the dealer must, within 30 days of ceasing to rely on the exception, notify the registered securities association with respect to a dealer who is a member of such association, or the appropriate regulatory agency with respect to any other dealer by using the electronic process or any other process prescribed by such association or agency.

(4) Documentation Requirement. A dealer relying on (2) above must document in its supervisory control procedures the factors used to determine that complete compliance with all of the provisions of (1) is not possible and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of (1) above to the extent practicable.

(B) procedures that are reasonably designed to review and monitor the following activities:

(1) all transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

(2) customer changes of address and the validation of such changes of address; and

(3) customer changes of investment objectives and the

validation of such changes of investment objectives.

The policies and procedures established pursuant to paragraph (f)(ii)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented. If a dealer does not engage in all of the activities enumerated above, the dealer must identify those activities in which it does not engage in its written supervisory control policies and procedures and document in those policies and procedures that additional supervisory policies and procedures for such activities must be in place before the dealer can engage in them; and

(C) procedures that are reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. For the purposes of this subsection only, the term "heightened supervision" shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the producing manager or the producing manager's office shall be attributed as revenue generated by the business units supervised by the producing manager's supervisor irrespective of a dealer's internal allocation of such revenue. A dealer must calculate the 20% threshold on a rolling, twelve-month basis.

(g) Definitions

(i) "Office of Supervisory Jurisdiction" means any office of a dealer at which any one or more of the following functions take place:

- (A) order execution and/or market making;
- (B) structuring of public offerings or private placements;
- (C) maintaining custody of customers' funds and/or securities;
- (D) final acceptance (approval) of new accounts on behalf of the dealer;
- (E) review and endorsement of customer orders, pursuant to paragraph (e) above;
- (F) final approval of advertising or sales literature for use by persons associated with the dealer, pursuant to Rule G-21(f); or
- (G) responsibility for supervising the activities of persons associated with the dealer at one or more other branch offices of the dealer.

(ii)(A) A "branch office" is any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any municipal security, or is held out as such, excluding:

- (1) Any location that is established solely for customer service and/or back office type functions where no sales activities are conducted and that is not held out to the public as a branch office;

(2) Any location that is the associated person's primary residence; provided that

a. Only one associated person, or multiple associated persons who reside at that location and are dealers of the same immediate family, conduct business at the location;

b. The location is not held out to the public as an office and the associated person does not meet with customers at the location;

c. Neither customer funds nor securities are handled at that location;

d. The associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, advertisements and other communications to the public by such associated person;

e. The associated person's correspondence and communications with the public are subject to the dealer's supervision in accordance with this rule;

f. Electronic communications (e.g., e-mail) are made through the dealer's electronic system;

g. All orders are entered through the designated branch office or an electronic system established by the dealer that is reviewable at the branch office;

h. Written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the dealer; and

i. A list of the residence locations is maintained by the dealer;

(3) Any location, other than a primary residence, that is used for municipal securities business for less than 30 business days in any one calendar year, provided the dealer complies with the provisions of paragraph (A)(2)(ii)a. through h. above;

(4) Any office of convenience, where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public as an office. Where such office of convenience is located on bank premises, signage necessary to comply with applicable federal and state laws, rules and regulations and applicable rules and regulations of the NYSE, other self-regulatory organizations, and securities and banking regulators may be displayed and shall not be deemed "holding out" for the purposes of this section;

(5) Any location that is used primarily to engage in non-securities activities and from which the associated person(s) effects no more than 25 securities transactions in any one calendar year; provided that any advertisement or sales literature identifying such location also sets forth the address and telephone number of the location from which the associated person(s) conducting business at the non-branch locations are directly supervised;

(6) The Floor of a registered national securities exchange where a dealer conducts a direct access business with public customers; or

(7) A temporary location established in response to the implementation of a business continuity plan.

(B) Notwithstanding the exclusions in paragraph (2)(A), any location that is responsible for

supervising the activities of persons associated with the dealer at one or more non-branch locations of the dealer is considered to be a branch office.

(C) The term "business day" as used (2)(A) shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

(iii) The term "appropriate regulatory agency" means the appropriate regulatory agency as defined in Section 3(a)(34) of the Act.

[1] The NASD and NYSE amendments are substantially similar. The rule changes were effective December 17, 2004 for NYSE member firms, and January 31, 2005 for NASD member firms.

[2] These provisions are derived from subsections (a)(3), (a)(4), (a)(5), (a)(6), and (a)(7) of NASD Rule 3010.

[3] The draft amendments to Rule G-27 define an "Office of Supervisory Jurisdiction" as any office of a dealer at which any one or more of the following functions take place:

- (A) order execution and/or market making;
 - (B) structuring of public offerings or private placements;
 - (C) maintaining custody of customers' funds and/or securities;
 - (D) final acceptance (approval) of new accounts on behalf of the dealer;
 - (E) review and endorsement of customer orders;
 - (F) final approval of advertising or sales literature for use by persons associated with the dealer;
- or
- (G) responsibility for supervising the activities of persons associated with the dealer at one or more other branch offices of the dealer.

[4] This provision was developed by the NASD to respond to two issues. First, it responds to concerns regarding the need for heightened supervision of certain registered representatives with troubled regulatory and compliance records. Second, it addresses the particular problems that occur when a firm hires a large number of individuals who formerly worked at a firm that has been expelled or has had its registration revoked and where they were inadequately supervised and trained.

[5] The stringency of the office inspection requirements is graduated and based on designations of offices under specifically defined categories, such as office of supervisory jurisdiction, supervisory and non-supervisory branch offices, and non-branch offices.

[6] A "branch office" is defined in G-27(g) as "any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding [certain enumerated locations]." A "supervisory branch office" is any non-OSJ branch office that is responsible for supervising one or more non-branch offices.

[7] If a dealer does not engage in any of these activities, then the dealer's supervisory control policies and procedures must note that the dealer is not engaged in these activities and that the supervisory control policies and procedures must be amended before a dealer may engage in them.

[8] As outlined in the guidance in NASD *Notice to Members 04-71* (October 2004).

[9] Underlining indicates additions; brackets indicate deletions.

Alphabetical List of Comment Letters on MSRB Notice 2006-11 (April 21, 2006)

1. BSC Securities: Letter to Ghassan Hitti, MSRB, from Larry Quinn, CPA, Vice President and Chief Financial Officer (May 1, 2006)
2. Investment Company Institute: Letter to Ghassan Hitti, MSRB, from Tamara K. Salmon, Senior Associate Counsel (June 2, 2006)



1-800-444-5371 • (903) 295-4250 • FAX (903) 295-4265
1800 N.W. LOOP 281, SUITE 100
LONGVIEW, TEXAS 75604

May 1, 2006

Municipal Securities Rulemaking Board
Attention: Ghassan Hitti, Assistant General Counsel
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

RE: Request for Comments on Draft Amendments to Rule G-27, on supervision, that strengthen supervisory procedures

Dear Sir:

In response to the request for comments, we are writing to express our general approval with the changes but at the same time express concern for unintended consequences of rulemaking. The stated purposes of the amendments are to 'adopt substantially similar rules' and 'help ensure a coordinated regulatory approach in the area of supervision and facilitate inspection and enforcement.'

As a small firm, we are intensely interested in anything that impacts our limited size and resources. While supportive of initiatives that provide customer protection and improve overall trust in the securities industry, we are also cognizant of the costs (direct and otherwise) incurred by the small firm in complying with rules and regulations.

With that in mind, we urge the MSRB to adopt changes, in this particular area of supervision, that are identical (not 'substantially similar') to other SRO's rules to ensure the coordination of regulatory approaches. We believe effective supervision comes with clear, unequivocal language and benefits everyone (examining authorities, firms and the general public) by avoiding additional interpretations, separate and slightly different supervisory procedures as well as dissemination of differences for training purposes of examining personnel and supervising personnel.

Again, we are supportive of your initiative and request you not create unintended consequences. Adopting rules that are identical in language to already established rules in use by other SROs would avoid the unintended consequence. Thank you for your attention to this comment and request.

Very truly yours,

Larry Quinn, CPA

Vice President and Chief Financial Officer



1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

June 2, 2006

Mr. Ghassan Hitti, Assistant General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

Re: MSRB Notice 2006-11
Relating to Supervisory Procedures

Dear Mr. Hitti:

The Investment Company Institute¹ is pleased to support the Municipal Securities Rulemaking Board's proposal to amend Rule G-27 to conform the supervisory requirements imposed on municipal securities dealers to those imposed on broker-dealers under NASD Rules 3010 and 3012.²

Conforming the MSRB's supervisory requirements to the NASD's will strengthen the current supervisory systems of municipal securities dealers because NASD rules require a more structured and formalized supervisory system than Rule G-27 in its current form. For example, unlike Rule G-27, NASD Rule 3010 requires broker-dealers to regularly conduct inspections of each of their offices. Imposing these more rigorous standards on municipal securities dealers should benefit investors by ensuring greater internal oversight of dealer operations.

The MSRB's proposal will also facilitate compliance by those dealers that are dually registered with the MSRB and the NASD. This is because, unlike under the current rules, there will be no substantive difference in the supervisory systems imposed by the rules of the MSRB and the NASD. This conformity should also enable the NASD to more efficiently inspect those dealers that are subject to rules of both self-regulatory organizations.

¹ The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

² See *Request for Comment on Draft Amendments to Rule G-27, on Supervision, that Strengthen Supervisory Procedures*, MSRB Notice 2006-11 (Apr. 21, 2006).

Mr. Ghassan Hitti, Assistant General Counsel

June 2, 2006

Page 2 of 2

The Institute commends the MSRB for its ongoing efforts to review its rules to ensure they remain current and consistent with those of the NASD. If you have any questions concerning these comments, please do not hesitate to contact me at (202)326-5825.

Sincerely,



Tamara K. Salmon
Senior Associate Counsel

cc. Ernesto A. Lanza, Senior Associate General Counsel

About the Investment Company Institute

The Investment Company Institute's membership includes 8,656 open-end investment companies (mutual funds), 657 closed-end investment companies, 167 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$9.251 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households.