MSRB REPORTS

Volume 5, Number 3 | Municipal Securities Rulemaking Board | April 1985

In This Issue

Also in this Issue

Important Request

The Board again stresses the importance to the rulemaking process of obtaining feedback on issues of concern to the municipal securities industry and urges readers to respond to the two exposure drafts published in this issue of *MSRB Reports*.

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Volume 5, Number 3 April 1985

Route To:

- ☒ Manager, Muni. Dept.
- ☒ Underwriting
- ☒ Trading
- ☒ Sales
- ☒ Operations
- ☒ Public Finance
- ☒ Compliance
- ☒ Training
- ☐ Other _____

Publication

Glossary of Municipal Securities Terms Published

In March, the Board published the *Glossary of Municipal Securities Terms*, an adapted version of a glossary entitled *Glossary of Municipal Bond Terms*, previously published by the Division of Bond Finance of the State of Florida. The Division—assisted by a wide variety of municipal professionals from throughout the country—wrote the glossary specifically for the Florida municipal securities market, but in so doing compiled information with a much broader application.

The Board obtained permission to revise the Florida glossary by updating references and incorporating definitions of terms of secondary market trading or regulatory significance. The Board believes that this revised edition will be useful to all persons active in the municipal industry, particularly those preparing for the Board's professional qualifications examinations. The definitions in the *Glossary of Municipal Securities Terms* do not represent definitions "officially" adopted by the Board, but do represent the consensus of industry professionals using these terms.

The Board hopes to update the *Glossary of Municipal Securities Terms* periodically to reflect industry comments and to incorporate new terminology. The Board welcomes suggestions from municipal securities professionals on revisions or additions to be included in future editions.

A copy of the glossary has been mailed to each municipal securities broker and dealer. Additional copies may be obtained from the Board offices at a cost of $1.50 per copy.

Calendar

May 15 —Comments due on the handling of misdirected interest payments

May 17 —Effective date of amendment to G-12 on use of post-original-comparison procedures of registered clearing agencies

June 1 —Comments due on automated price information dissemination

Pending —SEC approval of amendments to rules:

- A-12 on payment of initial fee
- G-3 on loss of qualification as principal
- G-12 on interest payment checks
- G-12 and G-15 on delivery of called securities
- G-12 and G-15 on original issue discount
- G-17 on "when-issued" securities
- G-19, G-26, and G-27 on suitability
- G-32, G-8, and G-9 on disclosures in connection with new issue securities
- G-35 on arbitration

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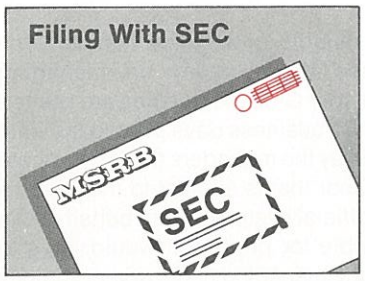

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Disclosures in Connection with New Issues: Rules G-32, G-8, and G-9

Principal Changes Proposed

The amendments would require that—

- **rule G-32 disclosures in final form, which include an official statement if prepared, be delivered to a customer by settlement date of the transaction;**
- **a preliminary official statement be delivered only when no final official statement has been prepared, along with a written notice that a final official statement has not been prepared;**
- **if a final official statement has been prepared, the financial advisor or the managing underwriter make the final official statement available in a timely manner;**
- **the managing underwriter be prepared to provide to a broker, dealer or municipal securities dealer that has purchased the new issue and has requested an official statement, one copy of the final official statement and other rule G-32 disclosures and one additional official statement per $100,000 par value of the new issue purchased; and**
- **a dealer maintain a record of deliveries of rule G-32 disclosures and retain this record for not less than a 3-year period.**

On March 11, 1985, the Board filed with the Securities and Exchange Commission final amendments to rule G-32 on disclosures in connection with new issues and to rules G-8 and G-9 on recordkeeping. The amendments are designed to delineate more clearly the responsibilities of dealers that sell new issue securities as well as to strengthen and facilitate enforcement of rule G-32. The Board published for comment draft amendments in March[1] and June 1984.[2] In September 1984, the Board adopted amendments to rules G-32, G-8 and G-9 which were filed with the Commission on October 23, 1984.[3] At its December 1984 meeting, after considering additional comments concerning these amendments, the Board determined to withdraw the amendments from the Commission pending further consideration by the Board.[4] That consideration recently was completed at the Board's February 1985 meeting at which the final amendments, described below, were adopted. In adopting the amendments the Board reviewed its prior drafts of amendments as well as all of the comments received thereon. The amendments will become effective 30 days after their approval by the Commission.

Background

Rule G-32 currently prohibits a municipal securities broker or dealer from selling during the underwriting period[5] new issue municipal securities to a customer unless, at or prior to sending the final confirmation of the transaction, a copy of the final official statement, if one is prepared by or on behalf of the issuer, and, in the case of negotiated sales, certain additional written information concerning the underwriting arrangements, are provided to the customer. The rule also requires dealers to furnish copies of official statements and other rule G-32 disclosures upon request to any broker, dealer, or municipal securities dealer to which it sells new issue municipal securities. The Board has stated that if sufficient copies of official statements are not available, a dealer must reproduce the official statement at its own expense. These requirements apply to all dealers who sell new issue securities, not solely to underwriters of the issue. The rule is designed to ensure that a purchaser of new issue securities is provided with all available information relevant to his investment decision.

Summary of Amendments

The amendments require that the rule G-32 disclosures, including an official statement in final form if any, be delivered by settlement of the transaction with a customer. Rule

Questions concerning these proposed amendments may be directed to Angela Desmond, General Counsel.

[1] *MSRB Reports*, vol. 4, no. 2 (March 1984).
[2] *MSRB Reports*, vol. 4, no. 4 (June 1984).
[3] See *MSRB Reports*, vol. 4, no. 6 (Nov. 1984) for a summary of those amendments.
[4] *MSRB Reports*, vol. 5, no. 1 (Jan. 1985).
[5] The underwriting period is defined in rule G-11(a)(ix) as:
. . . the period commencing with the first submission to a syndicate of an order for the purchase of new issue municipal securities or the purchase of such securities from the issuer, whichever first occurs, and ending at such time as the issuer delivers the securities to the syndicate or the syndicate no longer retains an unsold balance of securities, whichever last occurs.

G-32 currently requires that the rule G-32 disclosures be delivered to customers at or prior to sending the money confirmation of the transaction. The amendments would delay the deadline for delivery to the settlement of the transaction with a customer. The Board has extended the deadline for delivering rule G-32 disclosures to assure that a dealer has adequate time to deliver the disclosures to a customer and that the customer will receive the disclosures prior to paying for the securities.

In addition the amendments would require that when a final official statement is being prepared by or on behalf of an issuer, the final official statement must be delivered to a customer purchasing the new issue securities by the settlement of the transaction. Under current rule G-32, a dealer may have to bear the expense of mailing both the preliminary and, when it is prepared, the final official statement to customers. A number of dealers suggested that, in light of the expenses associated with obtaining and delivering official statements, the industry should only be required to send one disclosure document. The Board concluded that delivery of a preliminary official statement by itself would not be adequate in those instances in which a final version also is being prepared since the final official statement frequently differs materially from its preliminary version. The Board believes that requiring that final official statements be delivered is not unreasonable in light of the extension of the deadline by which rule G-32 disclosures must be delivered and other new requirements placed on managing underwriters and financial advisors summarized below.

For issues for which no final official statement will be prepared by or on behalf of an issuer, the amendments require that a dealer selling the new issue securities to a customer disclose that fact in writing by settlement of the transaction.

The amendments eliminate, in most instances, the requirement that a preliminary official statement be sent. Rule G-32 currently provides that when a final official statement is not prepared in time to send with the money confirmation, the preliminary version, if any, must be sent and the final official statement must be sent as soon as it becomes available from the issuer. As noted above, the amendments would require that the final version of the official statement be delivered by settlement of transactions in the new issue securities with customers. Under the amendments, therefore, there would be no need to deliver a preliminary official statement except in those instances in which a preliminary official statement is the only disclosure document prepared by or on behalf of the issuer. The Board understands that in some competitive sales, the issuers may prepare preliminary official statements only. In those circumstances, the amendments would require a dealer selling the new issue securities to deliver the preliminary version along with written notice that no final official statement will be prepared by settlement of the transaction with the customer.

When a final official statement will be prepared by or on behalf of the issuer the amendments would require the financial advisor and/or the managing underwriter to make the final official statement available in a timely manner. The amendments would place responsibility on managing underwriters to assure that rule G-32 disclosures are printed in final form no later than two business days prior to the date the securities are delivered by the managers to the syndicate members. A financial advisor that is subject to the Board's rules[6] and prepares an official statement on behalf of an issuer but is not responsible for printing it would have to deliver the final version to the managing underwriter promptly after the award is made so that the managing underwriter can complete printing within two business days prior to the date it delivers the securities to the syndicate members. If the financial advisor is responsible for printing the official statement, it must provide sufficient copies (as defined in paragraph (b)(i) of rule G-32) of the final version to the managing underwriter no later than two business days before the date the manager delivers the securities to the syndicate members. The Board has adopted these provisions because it understands that many dealers settle their customer transactions on the day the securities are delivered to the syndicate. It, therefore, concluded that it was necessary to specify these printing deadlines to facilitate compliance with the rule by these dealers.

The amendments specify that a managing underwriter must be prepared to provide to any broker, dealer or municipal securities dealer which has purchased the new issue, one copy of the final official statement and other documents specified by subsection (a)(ii) of rule G-32 and one additional official statement per $100,000 par value of the new issue purchased. A number of commentators suggested that it is difficult for dealers to comply with rule G-32 because some managing underwriters give the distribution of official statements a low priority. One commentator objected to the proposed amendments stating that it would be "forced" to violate rule G-32 in those instances in which it cannot obtain official statements from underwriters. The Board believes that managing underwriters should be responsible for ensuring that final official statements are printed in sufficient time and numbers to permit dealers to deliver them to customers by the settlement dates of transactions in the securities. This provision also would require a manager to provide instructions how to obtain additional official statements from the printer to any dealer seeking a larger number of the documents than is specified by the rule. These provisions are designed to achieve some balance between the costs associated with dissemination of official statements borne by underwriters and those borne by dealers selling new issue securities.

The amendments retain the existing rule G-32 provision that purchasing dealers must request the rule G-32 disclosures. In September, the Board adopted amendments to rule G-32 which would have required that purchasing dealers automatically receive the rule G-32 disclosures. After further consideration, the Board concluded that the primary purpose of the rule is to assure that public customers (rather than dealers) obtain the disclosures.[7] The Board concluded that compliance with the new requirement might delay, rather

[6]The Board does not have jurisdiction over "independent" financial advisors who are not registered with the SEC.
[7]Of course, a dealer must have sufficient knowledge of the issue in order to sell it, even though it might not have obtained a copy of the official statement for an issue.

than facilitate, delivery of the disclosures to customers, for example, when the securities trade among dealers several times in one or two days. Accordingly, the Board determined to delete the new requirement and restore the "on request" provision. The Board also concluded that a dealer at the end of a chain of inter-dealer transactions, which sells to a customer, should be able to obtain the disclosures directly from the syndicate manager and thereby avoid any lengthy delivery delays attendant to its seeking them through the transaction chain. The amendments, therefore, would require selling dealers and syndicate managers to provide rule G-32 disclosures promptly to such dealers on request. Thus, a purchasing dealer who must deliver rule G-32 disclosures to a customer could obtain them from the dealer which sold the securities to it or from the managing underwriter whichever way is appropriate to effect compliance with the rule.

The amendments would impose certain recordkeeping requirements on dealers. The amendments would add a new section to rule G-8 requiring a dealer to maintain a record of deliveries of rule G-32 disclosures and to rule G-9 to require that these records be retained for a period of not less than three years. The provisions allow dealers flexibility to determine how to maintain records of deliveries of rule G-32 disclosures. The Board adopted these requirements in September 1984, and continues to believe that they are necessary to assure compliance with and enforcement of rule G-32.

March 11, 1985

Text of Proposed Amendments*

Rule G-32. Disclosures in Connection with New Issues

(a) Disclosure Requirements. No ~~municipal securities~~ broker, dealer or municipal securities dealer shall sell, whether as principal or agent, any new issue municipal securities to a customer unless, ~~at or prior to sending a final written confirmation of the transaction to the customer indicating money amount due,~~ such ~~municipal securities~~ broker, dealer or municipal securities dealer ~~sends~~ delivers to the customer no later than the settlement of the transaction:

(i) a copy of the official statement in final form ~~voluntarily furnished~~ prepared by or on behalf of the issuer ~~(or an abstract or other summary of such statement which is prepared by such municipal securities broker or municipal securities dealer)~~ or if a final official statement will not be prepared by or on behalf of the issuer a written notice to that effect; and

(ii) in connection with a negotiated sale of new issue municipal securities, the following information concerning the underwriting arrangements:

(A) the underwriting spread;

(B) the amount of any fee received by the ~~municipal securities~~ broker, dealer or municipal securities dealer as agent for the issuer in the distribution of the securities;

(C) the initial offering price for each maturity in the issue that is offered or to be offered in whole or in part by the underwriters.

In the event an official statement in final form ~~is~~ will not be prepared by or on behalf of the issuer, ~~available at the time the final confirmation indicating money amount due is sent to a customer,~~ an official statement in preliminary form, if any, shall be sent to the customer, ~~provided that an official statement in final form, or an abstract or summary thereof, must be sent to the customer promptly after such official statement becomes available to the municipal securities broker or municipal securities dealer.~~ with a written notice that no final official statement is being prepared.

Every ~~municipal securities~~ broker, dealer or municipal securities dealer shall promptly furnish the documents and information referred to in this section (a) to any broker, dealer or municipal securities dealer to which it sells new issue municipal securities, upon the request of such broker, dealer or municipal securities dealer.

(b) Responsibility of Managing Underwriters, Sole Underwriters and Financial Advisors.

(i) Managing Underwriters and Sole Underwriters. When a final official statement is prepared by or on behalf of an issuer, the managing underwriter or sole underwriter, upon request, shall provide all brokers, dealers and municipal securities dealers that purchase the new issue securities with an official statement and other information required by paragraph (a)(ii) of this rule and not less than one additional official statement in final form per $100,000 par value of the new issue purchased by the broker, dealer or municipal securities dealer and shall provide all purchasing brokers, dealers and municipal securities dealers with instructions how to order additional copies of the final official statement directly from the printer. A managing underwriter or sole underwriter that prepares an official statement on behalf of an issuer shall print the final official statement and other information required by paragraph (a)(ii) of this rule and make them available promptly after the date of sale of the issue but no later than two business days before the date all securities are delivered by the syndicate manager to the syndicate members.

(ii) Financial Advisors. A broker, dealer or municipal securities dealer that, acting as financial advisor, prepares a final official statement on behalf of an issuer, shall make that official statement in final form available to the managing underwriter or sole underwriter promptly after the award is made. If the financial advisor is responsible for printing the final official statement, it shall make adequate copies of the final official statement available to the managing underwriter or sole underwriter promptly after the award is made but no later than two business days before the date all securities are delivered by the syndicate manager to the syndicate members to permit their compliance with paragraph (b)(i) of this rule.

~~(b)~~ (c) Definition of New Issue Municipal Securities and Official Statement. For purposes of this rule, the following terms have the following meanings:

(i) the term "new issue municipal securities" shall mean securities of an issue that are sold by a ~~municipal securities~~ broker, dealer or municipal securities dealer ~~to a~~

*Underlining indicates additions; broken rule indicates deletions.

~~customer~~ during the underwriting period defined in rule G-11 of the Board, and

(ii) the term "official statement" shall mean a document prepared by the issuer or its representatives setting forth, among other matters, information concerning the issuer and the proposed issue of securities. A notice of sale shall not be deemed to be an "official statement" for purposes of this rule.

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

(a) Description of Books and Records Required to be Made. Except as otherwise specifically indicated in this rule, every municipal securities broker and municipal securities dealer shall make and keep current the following books and records, to the extent applicable to the business of such municipal securities broker or municipal securities dealer:

(i) through (xii) No change.

(xiii) Records Concerning Deliveries of Official Statements. A record of all deliveries, to purchasers of new issue securities, of official statements or other disclosures concerning the underwriting arrangements required under rule G-32.

Rule G-9. Preservation of Records

(a) No change.

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

(i) through (ix) No change.

(x) all records of deliveries of rule G-32 disclosures required to be retained as described in rule G-8(a)(xiii).

(c) through (g) No change.

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Development of Automated Systems for Reporting of Municipal Quotations and Transaction Data

Principal Subjects Considered

The exposure draft sets forth questions on—

- **the nature of an automated quotations system, its desirability, its effect on the industry, and the role, if any, the Board should play in its development; and**
- **for the reporting of transaction data, the type of data to be released, the timing of its release, and the safeguards to be established to reduce risk of distortion or prevent manipulation of the data.**

Action: Send Comments

In recent months the Board has become aware that participants in the municipal securities industry are beginning to discuss the possibility of adopting more sophisticated automated systems for the dissemination of quotation information on municipal securities. At the same time the Board has learned that a system may be developed to provide for the release of aggregate transaction data derived from the facilities provided by the registered clearing agencies for the automated comparison of inter-dealer transactions in municipal securities. The Board is of the view that it would be desirable that parties likely to be affected by these developments have an opportunity early in the process of the development of such systems to consider the issues involved in their development and to express their views on the use of such systems in the municipal securities markets. Accordingly, this notice solicits comments from members of the municipal securities industry on these subjects generally and on several specific issues described below. The Board intends to use these comments to consider what action, if any, it should take with regard to these developments. The Board will also release a summary of the comments received to further the discussion of these important matters.

Quotations

A variety of media are currently used in the municipal securities industry for the dissemination of quotations on issues of municipal securities. Several daily publications carry quotation information (*e.g.*, listings of offerings, or representative bid-ask quotations on selected issues). In addition, several more sophisticated systems are available for the transmission of quotation information throughout the business day, including systems associated with industry publications as well as systems made available through certain of the municipal securities broker's brokers. Although these media appear to be adequate to meet the industry's present needs, when they are contrasted with the comparable media in use in other securities markets it seems clear that the information they provide is less complete, less current, and less available to the public. It appears possible, therefore, that steps to improve the current systems for the dissemination of quotations may increase the quantity and reliability of quotation information available to market participants and thereby enhance the efficiency of the trading markets for municipal securities.

In January 1984 one of the futures exchanges filed with the Commodity Futures Trading Commission a proposal for the trading of a futures contract on an index of long-term municipal securities. Under this proposal the value of the underlying index is to be determined through an evaluative pricing procedure conducted daily by certain of the municipal securities broker's brokers. In response to the CFTC's request for comment on the proposed contract, certain commentators suggested that a system for the automated dissemination of firm market quotations on index component issues should be developed, as this would provide a more sound basis for establishing the value of the index. These comments have prompted some discussion among various industry participants as to the desirability of such a system. In addition, the Board has been informed that various suppliers of quotation information—both persons currently active in the municipal market and persons not presently providing quotation information on municipal securities—are contemplating or working on the development of more sophisticated systems for the dissemination of quotations and market-making on issues of municipal securities. These developments have led the Board to conclude that it is likely that

Comments on the matters discussed in this notice should be submitted not later than June 1, 1985, and may be directed to Donald F. Donahue, Deputy Executive Director, or Angela Desmond, General Counsel. Written comments will be available for public inspection.

some type of automated system for the dissemination of firm market quotations on municipal securities will be introduced within the next several years. The issue of the use of automated quotations systems in the municipal securities industry, therefore, is one which deserves the current attention and consideration of all industry participants.

Some have suggested that certain of the systems in use in other segments of the securities industry may provide useful models of how a municipal automated market-making quotations system might operate. In the over-the-counter corporate equity securities markets, the National Association of Securities Dealers Automated Quotations ("NASDAQ") system provides a facility by which competing dealers maintain continuous two-sided markets in securities for which they are registered as market makers; quotations entered by market-making dealers are firm for a standard trading unit in the security (*e.g.*, 100 shares of stock), and can be changed through the system on a real-time basis throughout the course of the trading day. In the government securities markets firm quotations placed by one or more competing primary government securities dealers are disseminated over wires maintained by several of the government securities broker's brokers; there is no continuous market-making obligation with respect to specific issues, however, and the quotations may pertain only to one side of the market for the quoted security.[1] A consideration of what aspects of these systems, if any, would be usable or feasible in a municipal automated quotations system would also further the discussion of whether and, if so, how such a system should be developed.

The Board requests comments from interested members of the industry and the public concerning these issues. In particular, the Board seeks specific comment on the following questions:

1. Are there improvements which could be made in the present systems for the dissemination of quotations on municipal securities issues? If so, what are these? It may be possible that relatively simple changes in the existing systems for quotation dissemination might provide significant benefits in terms of increased efficiency in transmission of quotations or increased reliability in the quotation information provided. The development of a general industry consensus on what changes would be desirable or appropriate may prompt the expeditious adoption of these changes.

2. Would the development of an automated system for the dissemination of real-time quotations on municipal securities issues be useful for the industry, issuers and/or public investors? If so, why? It appears possible that such a system might contribute to an increase in the efficiency of the trading market for municipal securities and the amount of information available to the public regarding the market for particular issues and for municipal securities generally. Such developments, were they to occur, would presumably benefit both issuers and investors through more efficient pricing and execution of transactions; in turn, the increased efficiency in the market may encourage greater investor interest in municipal securities.

3. If so, to what extent do the systems presently in use in other segments of the securities industry provide useful models for a comparable municipal system? For example, quotations on over-the-counter equity securities disseminated on NASDAQ are firm for a standard trading unit. Adoption of such a firmness requirement in a municipal system would increase the currency and reliability of the quotation information provided; however, such a requirement might also impose serious difficulties on system participants (*e.g.*, an obligation to sell securities "short" under certain conditions) and therefore be impractical for a municipal system. Similarly, two-sided quotations, such as are currently displayed on NASDAQ, provide more complete information about the trading market for a security; however, it might be impossible for dealers to maintain two-sided markets on most municipal issues, due to their small supply and infrequency of trading.

4. How would the development of such a system affect the municipal market? As noted above, it appears possible that an automated system for the real-time dissemination of firm market quotations on municipal securities would provide benefits to issuers, investors and the industry itself. However, the concern has been expressed that such a system might also have a negative effect on certain market participants. For example, certain types of municipal securities brokers or dealers might be adversely affected by the adoption of such a system. Investors might lose interest in issues of securities—such as perhaps those of smaller issuers—which are not included on and quoted over such a system. Certain types of professional investors with access to the quotation information provided over such a system might be considered to derive unfair advantages over other types of investors who are less active in the market and therefore less willing to bear the expense of accessing this information.

5. If the development of such a system is desirable, how should the industry proceed toward its development? What should the role of the Board be in the development of such a system? It might be appropriate, for example, for market participants to develop a consensus as to what features such a system should have, so that parties interested in sponsoring such a system have a clear understanding of the desired structure. Alternatively, market participants might determine to express clearly the market's interest in the development of such a system, but leave the determination of the features of such a system (or competing systems) to the various vendors interested in sponsoring them.

Reporting of Transaction Data

On August 1, 1984, an amendment to Board rule G-12 became effective which required certain dealers effecting transactions in municipal securities to compare the transactions through the automated comparison facilities provided by the registered clearing agencies. As a result of this amendment a significant volume of data concerning secondary market transactions in municipal securities has been received by the registered clearing agencies: the registered

[1]More detailed descriptions of both of these systems are attached as appendices to this notice.

clearing agencies currently receive information on more than 3,000 inter-dealer transactions each day. It has been suggested that information about the municipal secondary market derived from this data could be of great use to the municipal securities industry.

The Board understands that the registered clearing agencies are contemplating establishing a mechanism for the release of certain aggregate data regarding transactions compared through the automated comparison system. It has been proposed that information derived from transaction volume data from the comparison system be used in connection with the proposed municipal futures contract, and, perhaps, released to the public as a part of that process. Provision for the release of other types of aggregate transaction information may also be made at some future time.

The Board believes that industry comment on the release of this type of transaction data would be helpful. In particular, the Board believes that comments would be desirable on the following questions:

1. What types of data, if any, should be released? The discussion to date has focused on the release of data concerning aggregate transaction volume by issue. Would the release of other data (*e.g.,* data on aggregate transaction prices by issue) be helpful? If so, what specific types of information would be desirable? Would the release of particular types of information have undesirable effects on different participants in the municipal market? If so, why?

2. Should special consideration be given to the timing of the release of the data? The data to be released will reflect information concerning transactions submitted to the system that have been compared; transactions that have failed to compare will not be reflected in the data released. Given the timing of the comparison cycle, the information released will reflect transactions effected several days prior to the release date. To what extent does this delay in the release of the data affect the utility of the information? Would a further delay in release of the data be helpful to avert undesirable effects of the data's dissemination? If so, why, and what are these effects?

3. What safeguards should be followed to eliminate or reduce the risk of distortion or manipulation of the data? It may be necessary to establish limitations on the data to be released to prevent the dissemination of distorted or misleading information or to forestall undesirable or inappropriate effects from release of the data. For example, it might be desirable that data not be released unless it reflected more than a minimum number of transactions or more than a minimum par value amount. What restrictions would be appropriate? Should these restrictions apply to all types of data, or only to certain types (*e.g.,* only to data on aggregate transaction prices, with transaction volume data reported on an unrestricted basis)? Should particular caution be exercised regarding how the data is described, to ensure that it is not misconstrued as a summary of information on all transactions in the municipal secondary market?

March 4, 1985

Appendix One

The NASDAQ System

The National Association of Securities Dealers Automated Quotations ("NASDAQ") system, made operational by the NASD in February 1971, is a system which provides real-time two-sided market quotations, entered by competing securities firms which are registered with the NASD as "NASDAQ market makers," on a variety of corporate equity issues traded in the over-the-counter market. The NASDAQ system consists of three levels of service available to various interested persons, as follows:

Level One service is available to a host of subscribers (both broker/dealers and others) to various quotation vendors, and can be accessed over a variety of terminal systems. Subscribers to Level One gain access to a quotation showing the best bid and asked dollar price on the 4,731 NASDAQ securities. The subscriber does not know who the NASDAQ market maker is showing that quotation, nor would he know if the quotation represents a single market maker or several (*e.g.,* if several firms list the best bid, or if different firms list the best bid and the best asked price).

Level Two service is available to subscribers (both broker/dealers and others) who gain access to the full listing of quotations on all NASDAQ securities, together with the identification of the market maker making each quotation and a listing of size, if any. The quotations are ordered in terms of price and time of entry, and can be accessed for either side of the market.[1] Quotations are firm for any listed size, or, if no size is shown, 100 shares.

Level Three service is available only to NASDAQ market makers. A Level Three subscriber would use the same equipment and have access to the same information as the Level Two subscriber, but would also be able to use the terminal to alter its own quotations (within a response time of approximately five seconds) on NASDAQ securities for which it is registered as a market maker.

To be listed on the NASDAQ system a security must meet certain criteria specified in NASDAQ rules. Generally, at least two registered market makers must have undertaken to make a market in the security (although, once listed, the security could continue to be listed on the system if one of these subsequently terminates its market-making activities). The security and its issuer must also meet certain tests concerning capitalization and other financial standards and distribution. Once a security is listed on NASDAQ, the NASD retains the right to impose "halts" on the trading of the security, in the event that, for example, news likely to affect the price of the securities is about to be released by the issuer.

Firms who register as market makers in a particular security are typically firms who have been involved in the underwriting of the securities or are otherwise active in the market for the issuer's securities. The issuer generally takes an active role in enlisting firms to serve as NASDAQ market makers. The process by which a firm "registers" as a NASDAQ market maker is relatively informal, with no filing or

[1]That is, a person interested in selling securities can access a quotation display ordered by bid price, and a person interested in buying can access a display ordered by asked price.

specific qualifications requirements imposed. A firm registered as a market maker for a particular security is obliged to make continuous markets in the security, and is not free to suspend or resume market-making activity at its discretion.

Appendix Two

Quotations Systems in the Government Securities Markets

The automated systems for the dissemination of quotations used in the government securities markets are less formal in structure and obligations than the NASDAQ system.[2] These systems are wire systems operated by six of the government securities broker's brokers which provide information concerning the market, including firm quotations on various issues of government securities, to subscribers. These "broker's screens" are generally available only to persons designated by the Federal Reserve Bank of New York as primary dealers in government securities, and generally cannot be accessed by other dealers in government securities or by public investors; one of the government securities broker's brokers, however, makes its screen available to all interested subscribers, and also lists quotations placed by persons other than primary dealers.

A typical broker's screen displays quotations on a range of government securities which have been provided to the broker by one or more primary dealers. Quotations on short term securities are expressed in basis prices; quotations on longer term securities are expressed in dollar price terms.

With respect to a particular issue, a particular broker's screen might display one quotation or several dealers' quotations. The same issue might be listed on several different brokers' screens, with different dealers providing quotations on the issue to different brokers, or one dealer providing its quotation to several brokers. A quotation on a particular issue displayed on a broker's screen might be a two-sided quotation (*i.e.*, both bid and offered side) or a quotation on one side of the market but no quotation on the other side (*e.g.*, a bid but not an offering); the bid and offered prices shown in a two-sided quotation need not be from the same dealer. It is possible that, once a transaction has been effected against a quotation displayed on a particular issue and the quotation has been withdrawn, there will no longer be a quotation available with respect to that issue and the issue will be dropped from the screen.

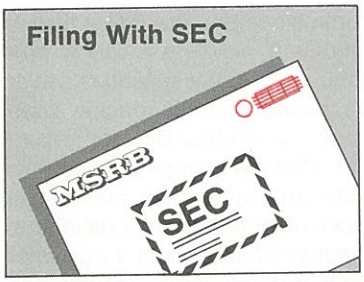
Quotations displayed are firm for any listed size or for a standard trading unit ($5,000,000 principal amount for short term securities, $1,000,000 principal amount for longer term securities). Once a transaction has been executed against a particular quotation, the dealer who had provided the quotation is no longer firm at that quotation unless it chooses to renew the quotation. Transactions effected against quotations shown on a broker's screen are also reported over the screen itself.

A primary dealer has no legal obligation to provide or maintain continuous market quotations on any particular issue of government securities, although its status as a primary dealer imposes on it an obligation to make markets in government securities generally. Similarly, its obligation to execute transactions against quotations displayed on a broker's screen is enforced through market pressure rather than regulatory action.

[2]This may, in part, be attributable to the fact that the government securities market, unlike the markets for corporate and municipal securities, is not subject to any formal structure of securities regulation.

MSRB REPORTS

Volume 5, Number 3 April 1985



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- ☒ Manager, Muni. Dept.
- ☐ Underwriting
- ☐ Trading
- ☒ Sales
- ☐ Operations
- ☐ Public Finance
- ☒ Compliance
- ☐ Training
- ☐ Other _____

Suitability of Recommendations to Customers: Rules G-19, G-26, and G-27

Principal Changes Proposed

The proposed amendments—

- **require that a municipal securities dealer has reasonable grounds based on available information to recommend a purchase or sale in a security and**
- **incorporate the suitability requirements of rule G-26 in rule G-19 and the supervision requirement of rule G-26 in rule G-27.**

The interpretive notice applies rule G-19 suitability requirements to—

- **dealers that recommend a transaction in a particular security during an investment seminar and**
- **dealers that make recommendations to customers who have responded to the dealer's advertisement.**

On March 1, 1985, the Board filed for approval by the Securities and Exchange Commission amendments to rule G-19, on suitability of recommendations and transactions, rule G-26, on administration of discretionary and other accounts, and rule G-27, on supervision. The amendments generally reorganize the rules to place all suitability requirements in rule G-19 and all supervision responsibilities in rule G-27. The provisions presently found in rule G-26 will be set forth in rules G-19 and G-27, and the rule would be deleted. The Board also wishes to clarify the application of rule G-19 to investment seminars and to customer inquiries made in response to advertisements published by a dealer.

Background

Rule G-19 on suitability.—Rule G-19 prohibits a municipal securities professional from recommending transactions in municipal securities to a customer unless the professional makes certain determinations with respect to the suitability of the transactions. The rule also specifies standards for effecting transactions in municipal securities for a discretionary account (as defined in rule D-10)[1] and prohibits "churning" of an account.[2]

Specifically, rule G-19 permits a municipal securities professional to make recommendations only if, after making a reasonable inquiry, he has reasonable grounds to believe, and does believe, that the recommendation is suitable for the customer on the basis of certain information provided by the customer or obtained from other reliable sources. This information should include the customer's financial background, tax status and investment objectives as well as any other similar information relevant to making a determination on suitability. In addition a professional must be aware of any changes in this information that would affect his investment recommendations.

The rule imposes an affirmative duty of inquiry on the professional and the customer's information must be kept up-to-date.[3] If a customer declines to provide the information requested and it is not otherwise known to the professional, a municipal securities professional is permitted to make a recommendation to a customer only if there are no reasonable grounds to believe and the professional does not believe that the recommended transaction is unsuitable. In addition, the Board has advised the industry that a municipal securities professional may recommend a securities transaction only if there is a reasonable basis for the recommendation.[4]

With respect to discretionary accounts, absent specific customer authorization of a transaction, rule G-19 bars a professional from effecting a transaction in municipal securities for a discretionary account if the professional does not have sufficient information to enable him to make an affirmative determination with respect to the suitability of the transaction for the customer.

Questions concerning these proposed amendments may be directed to Angela Desmond, General Counsel.

[1]Rule D-10 defines the term "discretionary account" to mean "the account of a customer carried or introduced by a broker, dealer, or municipal securities dealer with respect to which such broker, dealer, or municipal securities dealer is authorized to determine what municipal securities will be purchased, sold or exchanged by or for the account."
[2]Rule G-19(b), concerning churning, prohibits a dealer from recommending or effecting transactions that are excessive in size and frequency in view of information known to the dealer concerning the customer's financial background, tax status and investment objectives.
[3]While the rule does not specify the frequency with which information pertaining to suitability must be updated, the Board has stated that a professional must determine whether more current information than is in his possession is necessry to make a determination concerning suitability.
[4]Notice on Suitability, *MSRB Reports*, vol. 2, no. 5 (July 1982).

Rule G-26 on administration of discretionary and other accounts.—Rule G-26(a) requires a dealer to obtain certain information for each customer, as specified by rule G-8(a)(xi), at or before completion (*i.e.,* settlement) of a transaction in municipal securities.[5] Thus, a dealer is prohibited from transacting any business with a customer unless the customer provides it with the information (except for the tax identification number or social security number) specified in rule G-8(a)(xi).

Subsections (b) and (c) of rule G-26 require that a municipal securities principal obtain and accept written authorization from a customer for a discretionary account and that each transaction in a discretionary account be approved in writing by a principal. The rule also requires "regular and frequent" reviews of all customer accounts in which transactions in municipal securities are effected "in order to detect and prevent irregularities and abuses."

Rule G-27 on supervision.—The requirement that a municipal securities principal review active customer accounts on a frequent basis is reiterated in rule G-27 which requires a municipal securities dealer to supervise the municipal securities activities of its associated persons and the conduct of its municipal securities business. Rule G-27 specifies, among other things, that a municipal securities principal must be designated in writing to supervise a dealer's municipal securities activities. In addition, the rule requires a dealer to "establish, maintain and enforce written supervisory procedures" adopted by the dealer which must include the prompt review and written approval by the designated municipal securities principal of:

(A) the opening of each customer account introduced or carried by the municipal securities broker or municipal securities dealer, in which transactions in municipal securities may be effected;

(B) each transaction in municipal securities;

(C) the handling of all written customer complaints pertaining to transactions in municipal securities; and

(D) all correspondence pertaining to the solicitation or execution of transactions in municipal securities; and

(E) other matters required by rule of the Board to be reviewed or approved by a municipal securities principal or general securities principal or a municipal securities sales principal.

The supervisory procedures also must provide for the regular and frequent examination by the designated municipal securities principal (or the designated municipal securities sales principal) of customer accounts introduced or carrried by the municipal securities broker or municipal securities dealer, in which transactions in municipal securities are effected, in order to detect and prevent irregularities and abuses.

Summary of Amendments

The Board is incorporating subsections (a) and (b) of rule G-26 into rule G-19. As a result, rule G-19 will contain all of the suitability-related obligations applicable to brokers, dealers and municipal securities dealers. The Board also is revising the language of rule G-19, consistent with its previous interpretations, to require a municipal securities dealer to have reasonable grounds, based upon information available from the issuer of the security or otherwise, for recommending a purchase, sale, or other transaction in a security. This requirement is separate and apart from the current requirement that a dealer have reasonable grounds in light of financial and other information known about a customer for recommending a transaction in municipal securities to the customer.

With respect to supervision, the Board is incorporating the present provisions of rule G-26(c) into rule G-27 so that rule G-27 contains all of the supervision-related responsibilities applicable to municipal securities dealers. Rule G-26 is being withdrawn by the Board, and the rule will be reserved for future rulemaking.

Application of Suitability Requirements to Investment Seminars and Customer Inquiries Made in Response to a Dealer's Advertisements

The Board recently has been asked about the application of rule G-19 on suitability to recommendations made during investment seminars or to recommendations made to customers responding to an advertisement published by a dealer. As discussed earlier, rule G-19 prohibits a municipal securities professional from recommending transactions in municipal securities to a customer unless the professional makes certain determinations with respect to the suitability of the transactions.

The Board believes that rule G-19 applies to recommendations made by a professional at an investment seminar as follows: A dealer recommending a transaction in a particular security during the course of an investment seminar must have reasonable grounds for the recommendation in light of information about the security available from the issuer or otherwise. This duty applies to recommendations made generally to all participants in the seminar as well as to recommendations made to individual customers. In addition, a professional who makes a recommendation to a particular customer—whether during the course of the seminar or in response to an inquiry from the customer resulting from the customer's attendance at the seminar—must have reasonable grounds to believe and must believe that the recommendation is suitable for the customer in light of the customer's financial background, tax status, investment objectives and other similar information about the customer relevant to making a determination on suitability. If, after an inquiry by the professional, this information is not provided by the customer or otherwise known by the professional, the professional may make the recommendation only if he has no reasonable grounds to believe and does not believe that the recommendation is unsuitable for the particular customer.

The Board also wishes to advise the industry that the requirements of rule G-19 apply to recommendations made

[5]Rule G-8(a)(xi) on recordkeeping requires municipal securities brokers and dealers to obtain and record certain information concerning each customer. These items include the customer's name and address, the customer's tax identification or social security number, whether the customer is of legal age, and other, similar details. Should the customer refuse to provide a tax identification or social security number, the dealer may make a notation of this fact on the customer account information record and proceed to effect transactions for the customer.

Thus, if a customer places an unsolicited order for specific securities, the information required under rule G-8(a)(xi) is the only information the dealer specifically must record. However, if the customer seeks an investment recommendation, the dealer must, under rule G-19(a), inquire about other aspects of information including information concerning the customer's financial background, tax-status and investment objectives even though the information need not be recorded.

to customers who contact a dealer in response to an advertisement for municipal securities in the same way as they apply to all other recommendations made to customers.[6] As summarized above, if an individual contacts a dealer for additional information concerning municipal securities that were the subject of an advertisement, a professional is permitted to recommend a particular transaction to the individual only if he has reasonable grounds for recommending the security in light of information about the security available from the issuer or otherwise. Moreover, the professional may make the recommendation to the customer only if, after making a reasonable inquiry, he has reasonable grounds to believe and does believe that the recommendation is suitable for the customer on the basis of the financial and other information provided by the customer or obtained from other reliable sources.

March 1, 1985

Text of Proposed Amendments*

Rule G-19. Suitability of Recommendations and Transactions; Discretionary Accounts

(a) Account Information. Each broker, dealer, and municipal securities dealer shall obtain at or before the completion of a transaction in municipal securities with or for the account of a customer a record of the information required by rule G-8(a)(xi).

(b) Knowledge of Customer. Each broker, dealer or municipal securities dealer at or before recommending the purchase, sale or exchange of a municipal security to a customer shall have knowledge or shall inquire about the customer's financial background, tax status, and investment objectives and any other similar information.

~~(a) Customer Information.~~ (c) Suitability of Recommendations. No broker, dealer, or municipal securities dealer shall recommend the purchase, sale, or exchange of a municipal security to a customer unless such broker, dealer, or municipal securities dealer, after reasonable inquiry,

(i) has reasonable grounds based upon information available from the issuer of the security or otherwise for recommending a purchase, sale or other transaction in the security; and

~~(i)~~ (ii)(A) has reasonable grounds to believe and does believe that the recommendation is suitable for such customer ~~on the basis of information furnished by such customer~~ in light of the customer's financial background, tax status, and investment objectives and any other similar information concerning the customer known by such broker, dealer, or municipal securities dealer, or

~~(ii)~~(B) has no reasonable grounds to believe and does not believe that the recommendation is unsuitable for such customer if all of such information is not furnished or known.

Notwithstanding the foregoing, if a broker, dealer or municipal securities dealer determines that a transaction in municipal securities or in specific municipal securities would not be suitable for a customer and so informs such customer, ~~such~~ the broker, dealer, or municipal securities dealer may thereafter respond to the customer's requests for investment advice concerning municipal securities generally or such specific securities and may execute transactions at the direction of the customer.

~~(c)~~(d) Discretionary Accounts. No broker, dealer, or municipal securities dealer shall effect a transaction in municipal securities with or for a discretionary account

(i) except to the extent clearly permitted by the prior written authorization of the customer and accepted in writing by a municipal securities principal or municipal securities sales principal on behalf of the broker, dealer, or municipal securities dealer; and

(ii) unless the broker, dealer, or municipal securities dealer first determines that the transaction is suitable for the customer as set forth in paragraph (c)~~(i)~~(ii) of this rule or unless the transaction is specifically authorized by the customer.

~~(b)~~(e) Churning. No broker, dealer, or municipal securities dealer shall recommend transactions in municipal securities to a customer, or effect such transactions or cause such transactions to be effected for a discretionary account, that are excessive in size or frequency in view of information known to such broker, dealer, or municipal securities dealer concerning the customer's financial background, tax status, and investment objectives.

Rule G-26. ~~Administration of Discretionary and Other Accounts~~

[Delete rule; reserve rule number G-26 for future rulemaking.]

Rule G-27. Supervision

(a) through (b) No change.

(c) Written Procedures. Each municipal securities broker and muncipal securities dealer shall establish, maintain, and enforce written supervisory procedures adopted by the municipal securities broker or municipal securities dealer to assure compliance with the rules of the Board and applicable provisions of the Act and the rules and regulations thereunder. Such procedures shall provide, at minimum, for

(i) through (ii) No change.

(iii) the prompt review and written approval of each transaction in municipal securities effected with or for a discretionary account (unless the transaction is specifically authorized by the customer) introduced or carried by the municipal securities broker or municipal securities dealer and the regular and frequent examination by the designated municipal securities principal or the designated municipal securities sales principal of customer accounts introduced or carried by the municipal securities broker or municipal securities dealer, in which transactions in municipal securities are effected, in order to detect and prevent irregularities and abuses.

[6]Rule G-21, on advertising, defines an advertisement as—
. . . any material (other than listings of offerings) published or designed for use in the public media, or any promotional literature designed for dissemination to the public, including any notice, circular, report, market letter, form letter or reprint or excerpt of the foregoing. The term does not apply to preliminary official statements or official statements, but does apply to abstracts or summaries of official statements, offering circulars and other such similar documents prepared by municipal securities brokers or municipal securities dealers.

*Underlining indicates additions; broken rule indicates deletions; brackets indicate editorial explanation.

MSRB REPORTS

Volume 5, Number 3 April 1985

Route To:

- ☒ Manager, Muni. Dept.
- ☐ Underwriting
- ☐ Trading
- ☐ Sales
- ☒ Operations
- ☐ Public Finance
- ☒ Compliance
- ☐ Training
- ☐ Other _____

Processing of Interest Payment Claims: Rules G-12 and G-15

Principal Changes Considered

The draft amendments would provide that the parties filing interest payment claims—

- **direct them to the municipal securities broker or dealer that previously had delivered the securities,**
- **provide specified items of information, and**
- **be responded to in a specified time limit.**

Action: Send Comments

The Board is circulating for public comment certain draft amendments to the provisions of Board rules G-12 and G-15 regarding the clearance and settlement of inter-dealer and customer transactions. The draft amendments would establish requirements concerning the handling of claims for misdirected interest payments on registered securities. The draft amendments are being circulated for the purpose of eliciting comment prior to filing with the Securities and Exchange Commission.

In November 1984 the Board circulated for public comment a draft amendment to Board rule G-12 concerning the attachment of interest payment checks to deliveries of registered securities made too late to permit transfer of the securities prior to the record date.[1] The Board requested comment on several questions related to this subject, including whether it would be advisable to provide in Board rules for a standard procedure for claiming interest payments which had been directed to a person other than the rightful recipient.[2] The commentators responding to this aspect of the notice unanimously supported the adoption of an amendment incorporating such a procedure into the Board's rules.

Accordingly, the Board proposes to amend Board rule G-12 to add a new section concerning the filing and handling of claims for misdirected interest payments.

Significant Features of Draft Amendments

The significant features of this new section are as follows:

1. The draft amendment provides that parties filing interest payment claims on registered securities must direct them to the municipal securities broker or dealer who had previously delivered the securities. Although no standard procedure exists at the present time, the Board believes that most municipal securities brokers and dealers filing claims for misdirected interest payments on deliveries of securities currently direct such claims to the broker or dealer who delivered the securities to them, even though this party may not have been the recipient of the misdirected interest payment (*e.g.*, if the securities are registered in the name of this party's customer). Since these are the two parties to the transaction giving rise to the claim the Board believes that this method of transmitting the interest claim may be appropriate. Accordingly, this is the method of transmitting a claim prescribed under the draft amendment.

The Board recognizes, however, that, in cases in which certain registered securities are involved in a sequence of several transactions, it may be necessary that several interest payment claims be filed before a claim is made to the party who actually received the misdirected payment. Since in these instances the proposed procedure may impose some paperwork burden on intermediate dealers in a transaction sequence, the Board invites comments from industry members on alternative approaches that might alleviate these burdens.

2. The draft amendment prescribes certain standard items of information which must be provided on all interest payment claims. The Board believes that standardization of this information will ensure that recipients of interest payment claims are able to identify and process such claims promptly.

Comments on the draft amendments should be submitted not later than May 15, 1985, and may be directed to Harold L. Johnson, Assistant General Counsel. Written comments will be available for public inspection.

[1]Concurrently with the release of this exposure draft the Board is filing a revised version of this amendment with the Securities and Exchange Commission for its approval; *see* the March 7, 1985, notice of filing of these amendments in this edition of *MSRB Reports* at p. 19.

[2]For example, if a person who is the holder of record of certain registered securities sells the securities shortly before the record date prior to an interest payment date, and the new owner is unable to have the securities transferred prior to the record date, the previous owner will be sent the interest payment check. The new owner (or a person acting on the new owner's behalf) would then have to present a claim for the interest payment to the previous owner.

3. The draft amendment proposes certain time limits by which a response to an interest payment claim must be made. The Board understands that one of the major difficulties encountered by municipal securities brokers and dealers filing interest payment claims has been the absence of any requirement that the recipients of such claims process them within a certain period of time. The draft amendment addresses this problem by establishing two time limits. Under the draft amendment, a dealer receiving a claim for a current interest payment (a payment made not more than sixty days prior to the date of the claim) must respond to it within ten business days of its receipt; a dealer receiving a claim for an aged interest payment (a payment made more than sixty days prior to the date of the claim) must respond to it within twenty business days of its receipt. The Board believes that it would be appropriate to make this distinction in the standards applying to the timeliness of handling interest payment claims. The Board would welcome comments on the time periods proposed.

The Board also proposes to amend rule G-15 to include a comparable provision concerning the handling of interest payment claims from customers. This provision simply establishes a time period within which dealers must respond to such claims.

March 11, 1985

Text of Draft Amendments*

Rule G-12. Uniform Practice

( )Interest Payment Claims. A broker, dealer or municipal securities dealer entitled to receive from the issuer or its agent an interest payment on a security previously delivered to it who has not received such interest payment may claim such interest payment in accordance with this section.

(i) A broker, dealer or municipal securities dealer seeking to claim an interest payment shall send to the broker, dealer or municipal securities dealer against whom the claim is made a written notice stating, at minimum, the following:

(A) the name and address of the broker, dealer or municipal securities dealer making the claim;

(B) the name of the broker, dealer or municipal securities dealer against whom the claim is made;

(C) the amount of the interest payment which is the subject of the claim;

(D) the date on which such interest payment was scheduled to be made (and, in the case of an interest payment on securities which are in default, the original interest payment date);

(E) a description of the securities on which such interest payment was made; and

(F) a statement of the basis of the claim for the interest payment.

If the claim is made with respect to securities previously delivered to the claimant, the claim shall be directed to the broker, dealer or municipal securities dealer who had previously delivered the securities. If the claim is made with respect to securities previously delivered by the claimant with a coupon or an interest payment check incorrectly attached, the claim shall be directed to the broker, dealer or municipal securities dealer to whom the securities were delivered.

(ii) A broker, dealer or municipal securities dealer receiving a claim for an interest payment shall send to the claimant a draft or bank check for the amount of the interest payment or a statement of its basis for denying the claim promptly, but in no event later than the tenth business day after the date of receipt of the written notice of the claim (the twentieth business day, in the case of a claim involving an interest payment scheduled to be made more than sixty days prior to the date of the claim).

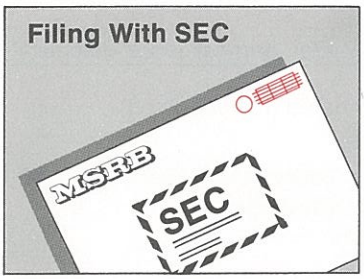
Rule G-15. Confirmation, Clearance and Settlement of Transactions with Customers

( ) Interest Payment Claims. A broker, dealer or municipal securities dealer who receives from a customer a claim for the payment of interest due the customer on securities previously delivered to (or by) the customer shall respond to the claim promptly, but in no event later than the tenth business day following the date of receipt of the claim (the twentieth business day, in the case of a claim involving an interest payment scheduled to be made more than sixty days prior to the date of the claim).

*All language is new.

MSRB REPORTS

Volume 5, Number 3 April 1985



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- ☒ Trading
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- ☒ Operations
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Confirmation Requirements for Original Issue Discount Securities: Rules G-12 and G-15

Proposed Rule Changes

The proposed amendments would require that confirmations of transactions in securities paying periodic interest and initially sold by underwriters as original issue discount securities contain a designation that the securities are original issue discount securities.

On March 6, 1985, the Board filed with the Securities and Exchange Commission proposed amendments to rules G-12 and G-15 which would require confirmations of transactions involving certain securities sold as original issue discount securities to include a designation of this fact. The proposed amendments will become effective 60 days following the date of Commission approval.

Background

An original issue discount security is a security sold at issuance at a discount from its par amount on which all or a portion of the return to be realized by the purchaser is in the accretion of the discount to par over the life of the security. A portion of the return on certain original issue discount securities is received as periodic interest payments at a stated interest rate, with the balance in accretion from the original issue discount to par. Others, such as "zero coupon" securities, pay no periodic interest, the entire return coming from the accretion of the discount to par.

The Board understands that the accretion of the discount of a tax-exempt original issue discount security, at least in part, generally is tax-exempt income to the holder. The Board believes that the fact that a security bears an original issue discount is material information since it may affect the tax treatment of the security and should affect the price of the security. Therefore, the Board previously has stated that this fact must be disclosed to a customer prior to or at the time of trade.[1]

The Board has received inquiries from members of the industry and purchasers of tax-exempt original issue discount securities which suggest that it is often difficult to determine whether securities traded in the secondary market are original issue discount securities, especially when such securities pay periodic interest. The Board is concerned that in transactions involving such securities an investor might not be aware that all or a portion of the component of his investment return represented by the accretion of the discount is tax-exempt, and therefore might sell the securities at an inappropriately low market price (*i.e.*, at a price not reflecting the tax-exempt portion of the discount) or may mistakenly pay capital gains tax on the tax-exempt portion of the accreted discount amount. In May 1984, the Board published an exposure draft of amendments that would require confirmation disclosure of original issue discount securities that pay periodic interest. The Board received one comment letter, which supported the draft amendments.

Summary of Amendments

The proposed amendments would require that confirmations of transactions in securities paying periodic interest and initially sold by underwriters as original issue discount securities contain a designation that the securities are "original issue discount" securities in order to facilitate identification of these securities in the secondary market. The requirement applies only to transactions in original issue discount securities on which periodic interest payments also are received. These securities, unlike "zero coupon" securities, may be easily mistaken for traditional tax-exempt securities for which the periodic interest payments are the only form in which investment return is received. The Board previously has adopted confirmation disclosure requirements for "zero coupon" securities, which are included in Board rules G-12(c)(v) and G-15(a)(v).

The Board considers that a designation of "OID" in the description field of a confirmation would satisfy the confirmation disclosure requirement for original issue discount securities paying periodic interest. The draft amendments would apply to all existing original issue discount issues that were identified as such when initially offered by the

Questions concerning the proposed amendments may be directed to Harold L. Johnson, Assistant General Counsel.

[1] *See* exposure draft on original issue discount securities, *MSRB Reports*, vol. 4, no. 3 (May 1984) at 7–8; *MSRB Manual* (CCH) ¶10,292 at 10,828.

underwriters, as well as to new issues identified by the underwriters as original issue discount securities. The Board understands that information concerning outstanding issues that were sold as original issue discount securities by the underwriters generally is available from industry sources.

March 6, 1985

Text of Proposed Amendment*

Rule G-12. Uniform Practice

(a) through (b) No change.

(c) Dealer Confirmations.

(i) through (v) No change.

(vi) In addition to the information required by paragraph (v) above, each confirmation shall contain the following information, if applicable:

(A) through (D) No change.

(E) if the securities pay periodic interest and are sold by the underwriter as original issue discount securities, a designation that they are "original issue discount" securities;

(E) through (F) renumbered (F) through (G).

(d) through (I) No change.

Rule G-15. Confirmation, Clearance and Settlement of Transactions with Customers

(a) Customer Confirmations.

(i) through (ii) No change.

(iii) In addition to the information required by paragraphs (i) and (ii) above, each confirmation to a customer shall contain the following information, if applicable:

(A) through (E) No change.

(F) if the securities pay periodic interest and are sold by the underwriter as original issue discount securities, a designation that they are "original issue discount" securities;

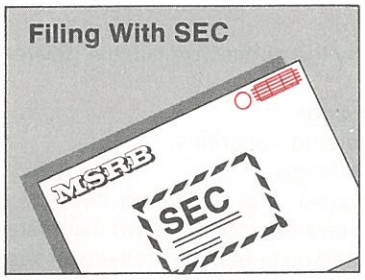
(F) through (G) renumbered (G) through (H).

(b) through (d) No change.

*Underlining indicates additions.

MSRB REPORTS

Volume 5, Number 3 April 1985



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- ☒ Manager, Muni. Dept.
- ☐ Underwriting
- ☐ Trading
- ☐ Sales
- ☒ Operations
- ☐ Public Finance
- ☒ Compliance
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- ☐ Other _____

Attachment of Interest Payment Check to Delivery of Securities Made After Record Date: Rule G-12

Proposed Rule Change

The amendment would require the attachment of an interest payment check to a delivery of registered municipal securities made after the record date on the security.

On March 7, 1985, the Board filed with the Securities and Exchange Commission an amendment to rule G-12(e)(xiv) on inter-dealer delivery of registered securities. The amendment requires that an interest payment check be attached to delivery of any registered municipal security when such delivery is made after the record date for the determination of payment of interest on the security. The proposed amendment will not become effective until approved by the Commission.

Background

Board rule G-12(e)(xiv)(G) currently provides that, unless otherwise agreed by the parties, a registered municipal security traded between dealers "and interest," which is delivered too late to accomplish a transfer of record ownership prior to the next interest payment date, must be accompanied by a draft or bank check for the interest payment, payable not later than the interest payment date or the delivery date, whichever is later. Rule G-12(e)(xiv)(H) contains similar provisions with respect to inter-dealer deliveries of defaulted securities on which an interest payment is to be made. The amendment filed will replace these provisions with a requirement that, unless otherwise agreed by the parties, an interest payment check must be attached to an inter-dealer delivery of registered securities made after the record date.

In recent months the Board has received numerous inquiries from municipal securities brokers and dealers concerning the requirements of rules G-12(e)(xiv)(G) and (H). In particular, members of the industry have sought further guidance concerning the application of the requirements to deliveries of securities made on or during the several days immediately prior to the record date for the securities. These inquiries have indicated to the Board that municipal securities brokers and dealers are interpreting these provisions in a variety of ways. Certain dealers, aware that transfer agents generally process transfer items submitted on or immediately before the record date on an expedited basis, attach interest payment checks only to deliveries of registered securities made after the record date for the securities, reasoning that "transfer of record ownership can . . . be accomplished" on any deliveries made on or prior to the record date. Other dealers assert that interest payment checks should be attached to any deliveries of registered securities made after three business days prior to the record date of the securities, in recognition of the three-day transfer turnaround requirements applicable to registered transfer agents under Securities and Exchange Commission rule 17Ad-2. Certain dealers also distinguish between issues handled by a professional agent and those handled by a non-professional agent (*e.g.*, the issuer itself), insisting that interest payment checks be provided at a much earlier time on the latter type of issue, due to the anticipated inefficiencies in the transfer process for such securities. These differences in practice have caused frequent disputes among dealers as to whether interest payment checks should be attached to deliveries made just prior to the record date of the securities and have led the Board to determine that further standardization in this area would be appropriate.

The Board solicited comments on an exposure draft of a amendment concerning the attachment of interest checks in November 1984.[1] The draft amendment would have required the attachment of an interest payment check on deliveries occurring *on or* after the record date. The Board received nine comment letters on the draft amendment, seven of which supported some definite industry standard for the attachment of interest payment checks, and five of which supported the draft amendment or the draft amendment with minor changes.

Summary of Amendment

In adopting the final amendment, the Board acceded to the suggestion of a number of commentators that interest payment checks should not be required to be attached to deliveries made on the record date, since receiving dealers

Questions concerning the proposed amendment may be directed to Harold L. Johnson, Assistant General Counsel.

[1] *MRRB Reports*, vol. 4, no. 6 (November 1984) at 7–8.

may well be able to accomplish transfer of record ownership of securities delivered on the record date when the transfer agent is located in the same city. Accordingly, the final amendment provides that the requirement of the attachment of an interest payment check to a delivery of registered securities shall apply only to a delivery made after the record date for the securities. Deliveries made on or prior to the record date would not be required, under the amendment, to be accompanied by an interest payment check. In circumstances where the securities delivered cannot be transferred by the record date, the receiving dealer would be obliged to file a claim for payment of the interest it is owned.[2]

The Board believes that the final amendment provides the most satisfactory solution to the difficulties caused by the lack of clarity in the present rules. The Board recognizes that there will be some cases in which securities delivered without an accompanying interest payment check (in accordance with the standard in the amendment) cannot be transferred by the record date. Nonetheless, the Board believes that in the majority of instances deliveries made on or prior to the record date can be submitted to the transfer agent in time to accomplish transfer prior to the determination of registered holders made on the record date.

March 7, 1985

Text of Proposed Amendment*

Rule G-12. Uniform Practice

(a) through (d) No change.

(e) Delivery of Securities. The following provisions shall, unless otherwise agreed by the parties, govern the delivery of securities:

(i) through (xiii) No change.

(xiv) Delivery of Registered Securities.

(A) through (F) No change.

(G) Payment of Interest. If a registered security is traded "and interest" ~~and transfer of record ownership cannot be accomplished on or before~~ a delivery of such security made on a date after the record date for the determination of registered holders for the payment of interest~~, delivery~~ shall be accompanied by a draft or bank check of the seller or its agent, payable not later than the interest payment date or the delivery date, whichever is later, for the amount of the interest.

(H) Registered Securities in Default. If a registered security is in default (i.e., is in default in the payment of principal or interest) and ~~transfer of record ownership cannot be accomplished on or before~~ a date for payment of interest due has been established, a delivery of such security made on a date after the date established as the record date for the determination of registered holders for the payment of interest~~, an interest payment date having been established on or after the trade date, delivery~~ shall be accompanied by a draft or bank check of the seller or its agent, payable not later than the interest payment date or the delivery date, whichever is later, for the amount of the payment to be made by the issuer, unless the security is traded "ex-interest."

(xv) and (xvi) No change.

(f) through (l) No change.

[2]The Board is currently considering the adoption of a rule providing a standard procedure for interest payment claims. See exposure draft on interest payment claim procedure, *MSRB Reports*, vol. 5, no. 3 (March 1985) at 15.

*Underlining indicates new language; broken rule indicates deletions.

MSRB REPORTS

Volume 5, Number 3 April 1985

Route To:

- ☒ Manager, Muni. Dept.
- ☒ Underwriting
- ☐ Trading
- ☒ Sales
- ☒ Operations
- ☐ Public Finance
- ☒ Compliance
- ☐ Training
- ☐ Other _____

Altering the Settlement Date on Transactions in "When-Issued" Securities: Rules G-17 and G-15

Summary of Interpretation

The municipal securities dealer that accepts a customer's payment for the "when-issued" securities before the new issue settlement date and specifies on the confirmation a settlement date weeks before the actual settlement date of the issue—

- **would violate rule G-17 if the customer is not advised that the interest received prior to settlement date probably would be taxable and**
- **would violate rule G-15(a) if the dealer specifies a fictitious settlement date on the customer confirmation.**

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

Rule G-17 provides that—

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

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

February 26, 1985

Questions concerning this notice may be directed to Diane G. Klinke, Deputy General Counsel.

MSRB REPORTS
Volume 5, Number 3 April 1985

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Arbitration: Rule G-35

Proposed Rule Changes

The proposed amendments would—

- **permit the Director of Arbitration to appoint a panel of three to five arbitrators to decide customer claims under $500,000,**
- **permit the arbitrators to bar at the hearing a repondent's arguments or defense if the respondent fails to submit an answer in a timely manner, and**
- **impose an adjournment fee on the party requesting and granted an adjournment after a panel of arbitrators has been chosen.**

On March 5, 1985, the Board filed with the Securities and Exchange Commission amendments to rule G-35, the Board's arbitration code. The amendments conform the provisions of the Board's arbitration code to recent amendments to the Uniform Arbitration Code developed by the Securities Industry Conference on Arbitration which is composed of the representatives of the Board, nine other self-regulatory organizations, four public members, and the Securities Industry Association. The amendments will become effective upon approval by the Commission.

Summary of Amendments

Arbitration Panels.—The proposed amendment to section 12 of rule G-35 would permit the Director of Arbitration to appoint an arbitration panel of from 3 to 5 persons to decide customer claims of up to $500,000, and 5 persons for claims over $500,000. This would modify the current provision which requires a panel of 5 arbitrators for any customer claim over $100,000 and would give the Director of Arbitration more flexibility in the formation of arbitration panels.[1] The proposed amendment also would allow the parties to waive their right to a 5-person panel.

Answers of Respondents.—The proposed amendment to section 5 would allow the arbitrators to decide whether a respondent who fails to file a timely answer may be barred from presenting any arguments or defenses at the hearing. This amendment is designed to encourage respondents to file answers in a timely manner so that claimants can prepare adequately for hearings.

Adjournment Fee.—The proposed amendment to section 20 would impose a fee on any party who requests and is granted an adjournment after arbitrators have been appointed. As the volume of arbitration cases increases, it becomes more difficult to reschedule adjourned hearings. In addition, adjournments increase costs and place an administrative burden on arbitrators and on the arbitration staff. The proposed fee would cover some of the costs associated with these adjournment requests. The arbitrators would be permitted to waive the adjournment fee when appropriate circumstances exist.

March 1, 1985

Text of Proposed Amendments*

Rule G-35. Arbitration

Sections 1 through 4. No change.

Section 5. Initiation of Proceedings

Except as otherwise provided herein, an arbitration proceeding under this Arbitration Code shall be instituted as follows:

(a) No change.

(b) (1) No change.

(2)(i) through (ii) No change.

(iii) A respondent, responding claimant, cross-claimant or third party respondent who fails to file an answer within 20 business days from receipt of service, or unless the time to answer has been extended pursuant to subsection (e) below, may, in the discretion of the artibrators, be barred from presenting any matter, arguments or defenses at the hearing.

(c) through (f) No change.

Sections 6 through 11. No change.

Section 12. Designation of Number of Arbitrators

(a) Controversies Involving Persons Other Than Municipal Securities Brokers or Municipal Securities Dealers

Questions concerning these proposed amendments may be directed to Diane G. Klinke, Deputy General Counsel.

[1]In inter-dealer controversies, the Code currently provides for a panel of from 3 to 5 arbitrators for claims of any amount.
*Underlining indicates new language; broken rule indicates deletions.

(1) Except as otherwise provided in this Arbitration Code, in all arbitration matters in which a person other than a municipal securities broker or municipal securities dealer is involved and where the matter in controversy does not exceed the amount of ~~$100,000~~ $500,000, or where the matter in controversy does not involve or disclose a money claim or the amount of damages cannot be readily ascertained at the time of commencement of the proceeding, the Director of Arbitration shall appoint an arbitration panel which shall consist of no less than three nor more than five arbitrators, at least a majority of whom shall not be associated with a broker, dealer or municipal securites dealer unless such person requests a panel consisting of a majority of arbitrators associated with a broker, dealer or municipal securities dealer.

(2) In all arbitration matters in which a person other than a municipal securities broker or municipal securities dealer is involved, and where the amount in controversy exceeds ~~$100,000~~ $500,000, the Director of Aribtration shall appoint an arbitration panel which shall consist of five arbitrators, unless the parties agree in writing to a panel of three arbitrators, at least three of whom shall not be associated with any broker, dealer or municipal securities dealer unless such person requests a panel consisting of a majority of arbitrators associated with a broker, dealer or municipal securities dealer.

(b) No change.

Sections 13 through 19. No change.

Section 20. Adjournments

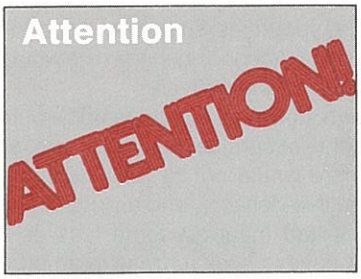
(a) The arbitrators may, in their discretion, adjourn any hearing either upon their own initiative or upon the request of any party to the arbitration.

(b) A party requesting an adjournment after arbitrators have been appointed, if said adjornment is granted, shall pay a fee equal to the deposit of costs but not more than $100. The arbitrators may waive this fee or in their award may direct the return of this adjornment fee.

Sections 21 through 35. No change.

MSRB REPORTS

Volume 5, Number 3 April 1985



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Letters of Interpretation

Rules G-12 and G-15—Confirmation Disclosures: Tender Option Bonds with Adjustable Tender Fees

This is in response to your letter requesting a one year delay in the effective date of an October 3, 1984, interpretation of Board rules G-12 and G-15 concerning confirmation disclosure of tender option bonds with adjustable tender fees. In that interpretation, the Board stated that the interest rate shown on the confirmation for these bonds should be the interest rate noted on the bond certificate (the "stated interest rate") but that the confirmation also must include the phrase "less fee for put." The Board also stated that it is the responsibility of the selling dealer to determine the current effective interest rate applicable to these bonds taking into account the tender fee (the "net interest rate") and to disclose this to purchasers at the time of trade. In addition, the Board took the position that the yield to maturity disclosure requirement does not apply to these bonds since an accurate yield to maturity cannot be calculated for these securities because of the annual adjustments to the tender fee. Dealers must, however, include the yield to the tender option date as an alternative form of yield disclosure.

While you agree with the interpretation, you state that the automated systems currently in place are not capable of complying with the interpretation and thus you request a one year delay in the effective date of this interpretation in order for the industry to effect necessary system modifications. Your request was referred to the Committee of the Board which has responsibility for interpreting the Board's confirmation rules. The Committee has authorized this reply.

Apparently, a problem arises when dealers include the stated interest rate in the interest rate field on the confirmation. In computing the yield on the transaction, most computer systems automatically pick up the rate in that field as the interest rate. Thus, an overstated yield based on the stated interest rate, instead of a yield based on the net interest rate, is printed on confirmations. We have been informed that certain dealers have solved this problem by including the net interest rate in the interest rate field. In this way, the computer automatically picks up the correct interest rate needed to determine the accurate yield to the tender option date. In order to solve the interest rate disclosure problem, these dealers include elsewhere in the description field of the confirmation the stated interest rate with the phrase "less fee for put." The Board believes that this method of disclosure is consistent with the Board's confirmation disclosure requirements.

Since the Board believes that most dealers will be able to comply either with the original interpretation or this clarification utilizing their present computer systems, it has decided not to approve any delay in the effective date of this interpretation for system modifications. We note, however, that any dealer that believes its system cannot comply with this interpretation might consider requesting a no-action letter from the SEC until its system modifications are in place.—*MSRB Interpretation of March 5, 1985, by Diane G. Klinke, Deputy General Counsel.*

Rule G-12—Delivery Requirements: Put Option Bonds

In a previous telephone conversation [name omitted] of your office had inquired whether any or all of the following deliveries of securities which are subject to a put option could be rejected:

(1) Certain securities are the subject of a "one time only" put option, exercisable by delivery of the securities to a designated trustee on or before a stated expiration date. An inter-dealer transaction in the securities—described as "puttable" securities—is effected for settlement prior to the expiration date. Delivery on the transaction is not made, however, until after the expiration date, and the recipient is accordingly unable to exercise the option, since it cannot deliver the securities to the trustee by the expiration date.

(2) Certain securities are the subject of a "one time only" put option, exercisable by delivery of the securities to a designated trustee on or before a stated expiration date. An inter-dealer transaction in the securities—described as "puttable" securities—is effected for settlement prior to the expiration date. Delivery on the transaction is made prior to the expiration date, but too late to permit the recipient to satisfy the conditions under which it can exercise the option (*e.g.*, the trustee is located too far away for the recipient to be able to present the physical securities by the expiration date).

(3) Certain securities are the subject of a put option exercisable on a stated periodic basis (*e.g.*, annually). An inter-dealer transaction in the securities—described as "puttable" securities—is effected for settlement shortly before the annual exercise date on the option. Delivery on the transaction, however, is not made until after the annual exercise date, so that the recipient is unable to exercise the option at the time it anticipated being able to do so.

I am writing to confirm my previous advice to him regarding the Board's consideration of his inquiry.

As I informed him, his inquiry was referred to a Committee of the Board which has responsibility for interpreting the "delivery" provisions of the Board's rules; that Committee has authorized my sending this response. In considering the inquiry, the Committee took note of the provisions of Board rule G-12(g)(iii)(C)(3), under which an inter-dealer delivery may be reclaimed for a period of eighteen months following the delivery date in the event that information pertaining to the description of the securities was inaccurate for either of the following reasons:

(i) information required by subparagraph (c)(v)(E) of this rule was omitted or erroneously noted on a confirmation, or

(ii) information material to the transaction but not required by subparagraph (C)(v)(E) of this rule was erroneously noted on a confirmation.

Under this provision, therefore, a delivery of securities described on the confirmation as being "puttable" securities could be reclaimed if the securities delivered are not, in fact, "puttable" securities.

The Committee is of the view that, in the first of the situations which he cited, the delivery could be rejected or reclaimed pursuant to the provisions of rule G-12(g)(iii)(C)(3). In this instance the securities were traded and described as being "puttable" securities; the securities delivered, however, are no longer "puttable" securities, since the put option has expired by the delivery date. Accordingly, the rule would permit rejection or reclamation of the delivery.

In the third case he put forth, however, this provision would not be applicable, since the securities delivered are as described. Accordingly, there would not be a basis under the rules to reject or reclaim this delivery, and a purchasing dealer who believed that it had incurred some loss as a result of the delivery would have to seek redress in an arbitration proceeding or in the courts. This may also be the result in the second case he cited, depending on the facts and circumstances of the delivery.

The Committee is aware, however, that, with the increasing issuance of municipal securities subject to various types of put options, there may be an increase in delivery problems similar to the latter two examples. The Committee has recommended to the Board that it monitor the incidence of these types of delivery difficulties, and, in the event that a significant number of such problems do occur, consider appropriate action to provide a remedy under the delivery provisions of the rules. The Committee would appreciate your keeping us advised of any future developments in this area.—*MSRB Interpretation of February 27, 1985 by Donald F. Donahue, Deputy Executive Director.*