MSRB REPORTS

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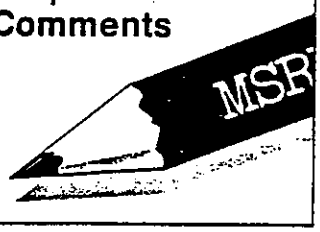
Request For Comments



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Specific Identification of Municipal Securities

In recent months the Board has been considering several closely-related questions bearing on the manner in which issues of securities which have the same issuer, interest rate, and maturity date but different dated dates, call provisions, and/or security or sources of payment are traded and delivered. The Board's discussions have focused particularly on the following questions:

1. **Fungibility**—Are securities of these issues fungible, *i.e.*, may they be grouped together in a single delivery on a single transaction, without regard to the differences between them?

2. **Specific Identification**—Must a dealer effecting a transaction in one of these issues identify at the time of trade which particular issue is involved in the transaction?

3. **Specific Description**—If a dealer must identify the particular issue at the time of trade, how must this identification be reflected on the confirmation?

These questions have arisen from several different sources, certain of which are reviewed below. In its consideration of these questions, however, the Board has been particularly mindful of their importance to the future development of more advanced systems for the comparison, clearance, and settlement of transactions in municipal securities. Such systems depend heavily on the use of a CUSIP-like security identification numbering system for purposes of data entry, comparison, and generation of instructions. If the industry is to adapt successfully to the use of such systems, some means must be found of coordinating the industry's current trading and delivery practices with the need to identify securities by their appropriate security identification number. This means that trading must be conducted in a manner that is sufficiently specific to permit identification of the precise security identification number needed for proper instructions to these advanced comparison and clearance systems, and that deliveries must also be made in accordance with this identification of the securities.* The Board believes that the questions referred to above concerning fungibility, specific identification, and specific description must be considered in the context of the changes necessary to further the development of more efficient comparison and clearance systems.

This notice reviews these questions in detail, sets forth the Board's current thinking on them, and solicits comments from the industry and interested members of the public concerning possible courses of action toward their resolution.

The Board is very interested in the views of municipal securities brokers, municipal securities dealers, issuers of municipal securities, and concerned members of the public regarding the questions and the proposals discussed in this notice. Written comments are welcomed, and should be submitted, not later than March 15, 1982, to Donald F. Donahue, Deputy Executive Director.

Fungibility

The Board has received inquiries from industry members concerning the degree to which securities must be identical to be fungible (*i.e.*, interchangeable) for delivery purposes. Dealers have inquired, for example, whether non-callable securities may be grouped together in a single delivery with callable securities of the same issuer, interest rate, and maturity date. Similarly, industry members have asked whether securities may be delivered without regard to differences in the "in whole" call provisions if the securities are otherwise identical. The Board responded to both of these inquiries indicating that the securities must be identical with respect to these features. The Board has responded in the same fashion to other, similar inquiries on other aspects of the required securities description.

On November 4, 1981 the Board filed with the Securities and Exchange Commission a proposed amendment to Board rule G-12 which would provide that all of the securities delivered on a single transaction must be identical with respect to certain specified elements of the securities description. These are

- the issuer, interest rate, and maturity date of the securities;
- whether the securities are subject to redemption prior to maturity;
- whether the securities are general obligation, limited tax, or revenue securities;

*At the same time, it is also necessary that the security identification numbering system minimize, to the extent possible, the distinctions drawn between issues, so as to alleviate possible unnecessary burdens on the trading and sales functions.

- the type of revenue, if the securities are revenue securities;
- the identity of any company or other person (in addition to the issuer) obligated on the debt service of the issue;
- the specific provisions of a call or advance refunding, if the securities have been called or advance refunded;
- the dated date and first coupon date, if the securities have an "odd" (short or long) first coupon; and
- the details of the "in whole" call provisions (optional redemption features), if any, applicable to the securities.

This amendment simply incorporated into a single section of the rule certain rule provisions and interpretive positions previously adopted by the Board. The Board believes that inclusion of this provision in the rule will clarify the current status of the question of the fungibility of different issues in deliveries, and will provide a basis for resolving the remaining aspects of the fungibility problem.

The Board's discussion of this "fungibility" question is currently focusing on certain remaining distinctions between securities, particularly (1) distinctions in the "in part" call provisions (extraordinary or sinking fund redemption features) applying to otherwise identical securities, and (2) distinctions in the security or sources of payment of the debt service on otherwise identical general obligation securities. The Board is of the view that such distinctions represent significant differences between issues of securities. For example, differences between the mandatory sinking fund requirements on two otherwise identical issues of securities may significantly affect the market value of the two issues, particularly at the time of the exercise of the sinking fund call or a request for sinking fund tenders. Similarly, differences between the security or sources of payment pledged to the debt service of two otherwise identical general obligation issues are often of significant interest to investors, with "double-barrelled" securities sometimes being preferred to securities backed solely by the general obligation of the issuer.

The Board is currently taking action to ensure that distinctions in the "in part" call provisions applying to otherwise identical securities are observed in deliveries. On December 16, 1981, the Board filed an amendment to its previously-filed rule change regarding fungibility of securities to specify that such "in part" call provisions must be identical on all securities delivered on a single transaction. Upon approval of this amendment the Board's rule will require that securities delivered on a transaction must be identical with respect to any applicable call feature, in addition to those items (listed above) currently required under rule G-12.

While the Board believes that it is equally important that distinctions in the security or sources of payment of otherwise identical securities be observed in delivery, the Board is aware that the CUSIP numbering system currently does not, in the case of general obligation bonds, generally recognize such distinctions in its assignment of CUSIP numbers. The Board has recently written to the CUSIP Service Bureau advising it that the Board believes strongly that these distinctions must be reflected in CUSIP number assignments on future new issues; the Board has also expressed its concern regarding the need to identify outstanding issues on which numbers have been assigned on a basis inconsistent with the Board's determination and arrange for correction of such number assignments. As changes are effected to remove impediments to making these distinctions in deliveries, the Board will consider further action to implement such a requirement.*

As noted above, the Board recognizes that, as the industry moves toward the use of automated processing and clearance techniques, it will become essential that the standards used in the assignment of CUSIP identification numbers be compatible with those governing the delivery of securities, so that, for example, two distinct CUSIP numbers are not assigned to securities which are fungible for delivery purposes. The standards which the Board is setting concerning the fungibility of municipal securities issues are, with the one indicated exception, in accord with the present method of CUSIP number assignment. In addition to these standards, the current CUSIP system also assigns different numbers to otherwise identical securities if such securities have different dates of issuance. The Board is currently reviewing the appropriateness of requiring that the securities delivered on a single transaction be identical with respect to the date of issuance or dated date. The Board would welcome industry comment on this proposal.

Specific Identification

The Board's consideration of the question of whether a dealer must specify (or be able to specify) at the time of trade the precise issue of securities involved in a transaction resulted from its continued monitoring of the industry's experience with the CUSIP number requirement.** Since CUSIP number assignments reflect (except as noted) all of the distinctions between securities of the same issuer, interest rate and maturity date discussed above, accurate selection of the correct CUSIP number would necessitate identification of the specific issue at the time of trade. At the time of the initial implementation of the CUSIP number requirement the Board recognized that the industry's lack of familiarity with the use of CUSIP numbers for municipal securities might unduly complicate this task of accurate selection of CUSIP numbers; accordingly, the Board provided, through interpretations and rule amendments, certain flexibility in the selection process during this initial implementation period. As emphasized earlier, however, the Board continues to believe that greater specificity in the identification of the issue of securities involved in a transaction (so as to permit the accurate selection of the proper CUSIP number on all transactions) is a goal which the industry must accomplish, in view of its importance to the development of automated comparison, clearance,

*Certain industry members have previously expressed concern over the possibility that the Board might request that CUSIP numbers be assigned to reflect the "purpose" of parts of a general obligation issue. The Board believes that a clear distinction must be drawn between the "purpose" of a general obligation bond (*i.e.*, that project or program which was financed by the proceeds of the new issue) and an additional security or "source of payment" of a general obligation bond (*i.e.*, specific funds or revenues that are pledged, over and above the general obligation pledge, to the debt service of that part of the issue). The Board believes that it is essential that CUSIP numbers reflect the latter type of distinction.

**As of January 1, 1979 inter-dealer confirmations and delivery tickets were required to set forth the "CUSIP number, if any, assigned to the securities" involved in the transaction.

and book-entry delivery systems. Since these systems have or will shortly become available for municipal securities transactions, the Board believes that reconsideration of this specific identification question is appropriate at this time.

The Board is also aware that certain industry members have found it necessary to adopt a policy of specifically identifying the issue of securities involved in a transaction in connection with the recent amendments to rule G-15. Compliance with these amendments necessitates, in certain circumstances, that dealers be able to identify the specific call features applicable to an issue of securities. These dealers, most of which maintain safekeeping positions for sizeable numbers of customers, have concluded that they must be able to identify the call features applying to all municipal securities they hold, so that, in those instances where compliance with rule G-15 necessitates identification of the call, they can do so without difficulty. The Board believes that this development also creates additional impetus for industry-wide adoption of a practice of identifying the specific issue of securities involved in transactions.

The Board proposes to mandate adoption of this practice through the revision of an existing interpretation regarding the effect of CUSIP number errors on deliveries of securities. One of the interpretations issued at the time of the initial implementation of the CUSIP number requirement provided that deliveries of securities could not be rejected solely due to an error in the CUSIP number shown on the delivery ticket. The Board proposes to revise this interpretation to specify that a delivery of securities bearing a CUSIP number other than that agreed upon at the time of trade (and reflected on the inter-dealer confirmations) may be rejected.* The Board believes that providing for rejection of a delivery in the event that the CUSIP number of the securities delivered does not correspond with that agreed upon at the time of trade will ensure that dealers adopt a policy on all transactions of specifically identifying the issue involved in the transaction, so as to ensure proper selection of the CUSIP number.

The Board welcomes comments on this approach.

Specific Description

The question of how specifically securities must be described on a confirmation is a necessary corollary of the specific identification issue described above. If dealers must specifically identify the particular issue of securities involved in a transaction, this identification must be reflected in some fashion on the transaction confirmation.

At this time the differences between issues that give rise to the need for specific identification at the time of trade are or will be reflected in the CUSIP numbers assigned to the issues. The Board is currently of the view, therefore, that the inclusion of the CUSIP number on the interdealer confirmation may be sufficient to identify the particular issue for securities description purposes. The Board would welcome comments on the adequacy of the CUSIP number designation as a means of describing a specific issue, or, alternatively, the need for further detail in the written securities description to achieve this end.**

*The Board notes that this interpretive position would only affect deliveries between dealers, and would not have application to a delivery of new issue securities from an issuer to the underwriters. In the latter case, if an incorrect CUSIP number were imprinted on the securities certificate, the Board's rules still would not give authority to the underwriters to refuse to accept the delivery. The underwriters would therefore have to arrange for the correction of the imprinting error before redelivery to customers and other dealers.
**The Board notes that CUSIP numbers are not currently required on customer confirmations. The Board would be particularly interested in the views of investors concerning the desirability of a CUSIP number requirement for customer confirmations.

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Exposure Draft

Rule G-34 on CUSIP Numbers

The Board has approved for circulation this exposure draft of a new rule, rule G-34, which would set forth certain requirements concerning the assignment of CUSIP numbers to new issues of municipal securities. The draft rule is being circulated for public comment prior to further consideration by the Board and filing with the Securities and Exchange Commission.

Board rule G-12 requires that inter-dealer confirmations and delivery tickets set forth the "CUSIP number, if any, assigned to the securities" involved in the transaction. The Board adopted this requirement, after extensive deliberation, due to its belief that the use of a uniform security identification system would promote efficiencies in the processing and clearance of municipal securities. The Board believes that the industry's experience with the CUSIP requirement since its January 1, 1979 effective date has generally been favorable, and that the industry has become acclimated to the use of security identification numbers in certain of its processing and clearance activities.

The Board is also of the view, however, that the industry's ability to make full use of the CUSIP identification system is significantly impaired by problems in the assignment of numbers to CUSIP-eligible new issues, and by the lack of imprinted numbers on the securities certificates. The absence of a standard procedure for requesting the assignment of CUSIP numbers to eligible new issues causes, in certain cases, lack of any number assignment at all, and, in other cases, assignment of numbers relatively late in the underwriting process. The absence of imprinted numbers on the securities certificates means that dealers are unable to compare the CUSIP securities identification on the delivery documents with the securities actually delivered, and, as a result, cannot easily use the CUSIP numbers to assure themselves that the issue contracted for is the issue delivered. Both of these deficiencies limit the usefulness of the CUSIP system in the industry's processing and clearance of transactions.

The Board believes that the full benefits of the use of the CUSIP system can be realized only if these deficiencies are resolved. Further, the industry's movement toward the use of automated trade comparison and netting systems and toward the immobilization of the municipal securities certificate will place greater emphasis on the need for full use of the CUSIP system in all aspects of the settlement and clearance of transactions. Failure to ensure assignment of numbers to eligible issues, and the absence of numbers on the certificates themselves, may prove a serious difficulty in adapting advanced clearance methods to the municipal securities industry.

Accordingly, the Board proposes to adopt requirements that would remedy both of these deficiencies. These requirements are proposed to be adopted pursuant to the Board's authority under section 15B(b)(2)(C) of the Securities Exchange Act of 1934, as amended, which directs the Board to adopt rules which are

> designed . . . to foster cooperation and coordination with persons engaged in . . . clearing, settling, processing information with respect to, and facilitating transactions in municipal securities . . .

The proposed requirements are described below.

The text of the draft rule follows this notice. All interested persons are invited to submit written comments to the Board on the draft rule. Letters of comment should be submitted to the Board on or before March 15, 1982, and should be sent to the attention of Donald F. Donahue, Deputy Executive Director. Written comments will be available for public inspection.

Number Assignment

Draft rule G-34(a) would require that underwriters of new issues of municipal securities which are eligible for CUSIP number assignment* apply for assignment of such numbers during the initial stages of the underwriting process. The underwriters would also be required to supply in the application process certain information, specified in the draft rule, regarding the new issue in order to facilitate the correct number assignment. Underwriters would be required to make

*The CUSIP system's eligibility rules currently specify that CUSIP numbers will be assigned to any municipal issue (with the general exception of issues of local assessment bonds or notes of one year or less to maturity) which meets one of the following criteria:
(1) the issue has a par value of $500,000 or more;
(2) the issue has a par value of $250,000 or more, and the issuer has outstanding debt in excess of $250,000; or
(3) the issuer has outstanding debt in excess of $500,000, and a CUSIP subscriber requests assignment of a number to an issue (of any par amount).

such application as promptly as possible. The Board intends that such application should be made at a time sufficiently early in the underwriting process to permit the imprinting of the numbers on the securities certificates and the dissemination of the numbers in time for inclusion on dealer confirmations.

The draft rule would require that underwriters make application for CUSIP number assignment to the Board, or to an entity designated by the Board. The Board intends to designate the organization assigning CUSIP numbers to receive such applications on its behalf, so that underwriters will apply for CUSIP numbers directly to the organization responsible for assigning them. This will ensure that number assignments will be made expeditiously.

Number Affixture

Draft rule G-34(b) would require that underwriters ensure that the CUSIP number applying to a new issue of municipal securities is affixed to the securities certificates prior to distribution of such securities to customers, syndicate members, or other dealers. The draft rule would permit the underwriter to affix the CUSIP number by means of a rubber stamp, stickering, or other similar method. As a practical matter, the Board anticipates that most managers would arrange to have the numbers imprinted during the normal certificate printing process.

* * *

The Board welcomes comments on the draft rule. In addition to the general proposals of the draft rule, the Board would particularly welcome comment on the following issues:

(1) Should the rule establish a specific time limit by which application for the CUSIP number assignment must be made? If so, what time limit would be appropriate for competitive issues? What time limit would be appropriate for negotiated issues?

(2) Are the items of information to be provided in connection with the number assignment sufficient to ensure correct assignment? Should other items of information be provided? If so, which items?

(3) Should an attempt be made to affix CUSIP numbers on outstanding issues of municipal securities? If so, how should this be done?

Text of Draft Rule

Rule G-34. CUSIP Numbers

(a) Each municipal securities broker or municipal securities dealer who acquires, whether as principal or agent, a new issue of municipal securities from the issuer of such securities for the purpose of distributing such new issue shall apply to the Board or its designee for assignment of a CUSIP number. The municipal securities broker or municipal securities dealer shall make such application as promptly as possible. In making such application, the municipal securities broker or municipal securities dealer shall provide to the Board or its designee the following information:

(i) complete name of issue and series designation, if any;

(ii) interest rate(s) and maturity date(s) (*provided, however,* that, if the interest rate is not established at the time of application, it may be provided when it becomes available);

(iii) date of issuance;

(iv) type of issue (general obligation, limited tax or revenue);

(v) type of revenue, if the issue is a revenue issue;

(vi) details of all redemption provisions;

(vii) the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to the debt service on all or part of the issue (and, if part of the issue, an indication of which part); and

(viii) any distinction(s) in the security or source of payment of the debt service on the issue, and an indication of the part(s) of the issue to which such distinction(s) relate.

(b) Each municipal securities broker or municipal securities dealer who acquires, whether as principal or agent, a new issue of municipal securities from the issuer of such securities for the purpose of distributing such new issue shall affix to, or arrange to have affixed to, the securities certificates of such new issue the CUSIP number assigned to such new issue pursuant to the requirements of section (a) of this rule. If more than one CUSIP number is assigned to the new issue, each such number shall be affixed to the securities certificates of that part of the issue to which such number relates.

(c) In the event a syndicate or similar account has been formed for the purchase of a new issue of municipal securities, the managing underwriter shall take the actions required under the provisions of this rule.

(d) The provisions of this rule shall not apply to a new issue of municipal securities which does not meet the eligibility criteria for CUSIP number assignment as established by the CUSIP Board of Trustees.

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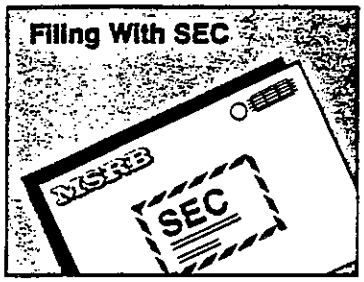

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Rule G-12

Amendments Filed on Fungibility

The Board filed on November 4 and December 16, 1981, two amendments affecting the fungibility (interchangeability) for delivery purposes of different issues of municipal securities. The two amendments are discussed below.

November Amendment

The amendment filed on November 4, 1981, specified that, with respect to a delivery of securities on an inter-dealer transaction, all of the securities delivered must be identical with respect to (1) each of the elements of a securities description specified in subparagraphs (c)(v)(E), (c)(vi)(A), and (c)(vi)(C) of rule G-12,* and (2) the details of the "in whole" call provisions of such securities (*i.e.*, those provisions under which the issuer of the securities may call the whole of the issue, or the whole of a maturity of the issue). This amendment incorporated into the section of rule G-12 pertaining to "good delivery" certain requirements governing the fungibility of municipal securities for delivery purposes which had previously been reflected solely in the "reclamation" section of the rule, in the case of the first requirement, and as an interpretation of such section, in the case of the second requirement. The Board notes that the substantive provisions of this amendment were effective and applicable to inter-dealer deliveries of municipal securities at the time of filing of the amendment; the amendment simply accomplished the technical result of setting forth the requirements in the appropriate section of the rule.

December Amendment

On December 16, 1981 the Board filed a change to the above amendment to specify that, in addition to the items previously covered in the rule, all of the securities delivered on a transaction must be identical with respect to the details of the "in part" call provisions of such securities (*i.e.*, those provisions, such as "sinking fund" features or extraordinary redemption features, under which the issuer of the securities may, or would be likely to, call only a part of the issue). This change would have the effect of requiring that all securities delivered on a transaction must be identical with respect to any call provision applying to such securities.

The Board is of the view that any call provision is a significant aspect of a security's description, and that different call features can have different effects on the market value of a security or the likelihood that it will be called. Accordingly, the Board concluded that any call feature distinction should be recognized when delivering securities, and otherwise identical securities having differences in the specifics of the applicable call provisions should not be considered to be fungible for delivery purposes.

The text of the amendment filed in November, as modified by the amendment filed in December, is set forth below.

Questions or comments concerning the amendments should be directed to Donald F. Donahue, Deputy Executive Director.

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) No change.

(ii) Securities Delivered. All securities delivered on a transaction shall be identical as to the information set forth in subparagraph (E) of paragraph (c)(v) and, to the extent applicable, the information set forth in subparagraphs (A) and (C) of paragraph (c)(vi). All securities delivered shall also be identical as to the call provisions of such securities.

(ii) through (xv) renumbered as (iii) through (xvi). No substantive change.

(f) through (l) No change.

*Rule G-12(c)(v)(E) requires that securities descriptions on inter-dealer confirmations contain the following specific items of information:
name of the issuer, interest rate, maturity date, and if the securities are limited tax, subject to redemption prior to maturity (callable), or revenue bonds, an indication to such effect, including in the case of revenue bonds the type of revenue, if necessary for a materially complete description of the securities and in the case of any securities, if necessary for a materially complete description of the securities, the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to debt service or, if there is more than one such obligor, the statement "multiple obligors" may be shown . . .
Rule G-12(c)(vi)(A) requires that such confirmations specify
dated date if it affects the price or interest calculation, and first interest payment date, if other than semi-annual . . .
and rule G-12(c)(vi)(C) requires,
if the securities are "called" or "pre-refunded," a designation to such effect, the date of maturity which has been fixed by the call notice, and the amount of the call price . . .

**Underlining indicates additions.

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Application of Board's Rules to Municipal "Commercial Paper"

In a recent letter to the Office of the Comptroller of the Currency, the staff of the Securities and Exchange Commission has taken the position that certain short-term tax-exempt notes issued by a municipal issuer and marketed as municipal "commercial paper" would constitute "municipal securities" as defined in the Securities Exchange Act of 1934 and, therefore, be subject to the Board's rules.

The Board believes that most of its rules will apply to municipal "commercial paper" which is deemed to be municipal securities in the same way as they do to more traditional municipal securities. The Board has determined to express its views at this time concerning the application to such municipal "commercial paper" of certain provisions of Board rules G-3 on professional qualifications, G-12 on uniform practice, and G-15 on customer confirmations.

Professional Qualifications

The Board wishes to remind securities professionals that persons effecting transactions in such municipal "commercial paper" must be qualified as municipal securities representatives or general securities representatives. Further, dealers who effect transactions in such municipal "commercial paper" must be designated with the Board, pursuant to rule A-12, as municipal securities dealers.

Confirmation

A. Customer Confirmations of "Rollover" Transactions

Rule G-15(a) requires that at or before completion of a municipal securities transaction with a customer, a municipal securities dealer or broker must send the customer a written confirmation. In the Board's view this requirement will apply not only to the initial sale of municipal "commercial paper" to a customer but also to any "rollover" transaction with a customer. Thus, if a municipal securities dealer effects a "rollover" transaction with a customer, the dealer must, prior to completion of the transaction, send the customer a written confirmation containing the information specified in the rule.

B. Confirmation Disclosures for Transactions in Municipal "Commercial Paper" Traded on a Discounted Basis

As indicated above, rule G-15 sets forth certain requirements concerning the information to be set forth in customer confirmations of transactions in municipal securities; rule G-12(c) sets forth comparable requirements concerning interdealer confirmations. Among other items, both rules require that confirmations contain information concerning the yield of the transaction* and detail of the principal and interest dollar amounts.

On October 23, 1981 the Board filed with the Commission certain amendments to these rules which are designed to establish appropriate confirmation requirements for municipal securities traded on a discounted basis, rather than on the basis of a yield or dollar price. Upon approval by the Commission these new confirmation disclosure provisions will apply to municipal "commercial paper" sold on a discounted basis.

* * * * * *

The Board intends to continue considering the application of its rules to municipal "commercial paper" and welcomes the written comments of industry members and other interested persons concerning this subject. Based on such further consideration the Board may modify the views expressed herein.

The text of the Commission's letter follows. Questions concerning whether particular issues of municipal "commercial paper" are "municipal securities" should be directed to the Commission's Division of Market Regulation. To the extent that such issues are deemed to be "municipal securities," and therefore subject to the Board's rules, the interpretations contained in this notice would apply.

Questions relating to this notice may be directed to Richard B. Nesson, General Counsel.

*Rule G-12 requires disclosure of the yield only if the yield is the price basis of the transaction.

Securities and Exchange Commission
Washington, D.C. 20549

August 12, 1981

Owen Carney, Director
Investment Securities Division
Office of the Comptroller of the Currency
490 E. L'Enfant Plaza, S.W.
Washington, D.C. 20215

This is in response to your letter dated February 11, 1981, requesting our views concerning a transaction proposed by a national bank (the "Bank"). Specifically, you have inquired whether certain short-term, tax-exempt notes issued by a publicly-owned utility and which you characterize as "municipal commercial paper" are municipal securities within the meaning of that term in Section 3(a)(29) of the Securities Exchange Act of 1934 (the "Exchange Act").[1] Based upon your letter and subsequent conversations, we understand the facts to be as follows.

The Bank, which is registered with the Commission as a municipal securities dealer pursuant to Section 15B of the Act, together with three other banks, is currently lending funds to the utility for the construction of pollution control facilities, pending the issuance by the utility of an industrial development bond. The Bank proposes to convert the entire loan to short-term, tax-exempt notes[2] and to market the notes as "municipal commercial paper" with maturities of up to 270 days. The Bank would sell the notes in denominations from $100,000 to $1 million as "agent" to correspondent banks and tax-exempt mutual funds. No sales will be made to individuals or trust accounts. As the promissory notes mature, they would be "rolled-over" and resold either to the original purchasers or to other investors. It is expected that approximately $50–$60 million in financing would be obtained in this manner.

The municipal commercial paper would be backed by the utility's promise to pay the principal of the paper upon maturity. As part of the total financing package, the Bank would make available a line of credit to fund the needs of the utility if the Bank is unable to sell the notes, either at the time the notes are initially offered or as they are "rolled-over." The Bank would also issue a standby letter of credit payable to the holder of the commercial paper in the event of default by the utility. The letter of credit would be secured by a first lien on the pollution control facility. The municipal commercial paper would eventually be paid with the proceeds from the issuance of pollution control industrial development bonds.

Section 3(a)(29) of the Exchange Act defines municipal securities as:

> *securities* which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, . . . or any security which is an industrial development bond (as defined in Section 103(c)(2) [103(b)(2)] of the Internal Revenue Code of 1954) . . . . (emphasis added).

Section 3(a)(10) of the Exchange Act excludes from the definition of security ". . . any note, draft, bill of exchange or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." This provision in the Exchange Act is similar to the commercial paper exemption in Section 3(a)(3) of the Securities Act of 1933 (the "Securities Act"). Section 3(a)(3) of the Securities Act treats as exempted securities:

> any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

In Securities Act Release No. 4412 (September 20, 1961) (hereinafter "Release No. 4412"), the Commission interpreted these requirements, stating that the exemption in Section 3(a)(3) is available for (1) prime quality negotiable paper (2) of a type not ordinarily purchased by the general public (3) used to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by federal reserve banks.

As a general matter, the sale of tax-exempt commercial paper, both of the type you have described, and as issued by municipalities for their own use,[3] appears to be a recent market development, and differs from the commercial paper which was prevalent in the 1930's and which Congress sought to exempt from registration under the Securities Act and general regulatory requirements of the Exchange Act.[4] The primary distinguishing characteristic is, of course, the tax-exempt nature of municipal commercial paper, but it also appears that the municipal commercial paper you describe is issued for purposes other than the types of "current transactions" that characterize traditional commercial paper.

In this regard, it is important to note that the Commission's staff has granted a number of no-action positions under Section 3(a)(3) of the Securities Act for the sale of commercial paper by entities, including the sale of commercial paper issued by utilities. The proceeds from the sales of such paper issued by utilities have been used in a number of ways, including working capital, and for "additions to and extensions of the utility properties."[5] The commercial paper which was issued by these entities was generally part of the enterprise's need for working capital and, although the proceeds were used during a period of construction, the commercial paper was not issued solely for the specific purpose of constructing a single permanent facility for use by the issuer.[6]

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[1] 15 U.S.C. § 78c(a)(29).

[2] According to the Bank, interest on the notes is tax-exempt under Section 103 of the Internal Revenue Code. Section 103(b)(4) of the Code provides an exemption from federal income taxation for interest on an industrial development bond, the proceeds from which are used to construct air or water pollution control facilities.

[3] See *Wall Street Journal*, June 3, 1981, p. 42.

[4] Consistent with this position is the fact that municipal commercial paper, whether issued by a municipality for its own purposes, or by a corporation through an industrial development authority for construction of facilities, is exempt from the registration provisions of the Securities Act pursuant to Section 3(a)(2) of that Act.

[5] See letter dated April 8, 1978, from Richard K. Wulff, Attorney, Division of Corporation Finance to David S. Brolliar, Esq., Hunton & Williams (Virginia Electric and Power Company); and letter dated August 6, 1981, from William E. Toomey, Assistant Chief Counsel, to Edward C. Roberts, Esq. (South Carolina Electric & Gas Company). See also, letters dated April 10, 1979 from Richard K. Wulff and July 14, 1979, from Norman Schou, Special Counsel, Division of Corporation Finance to Victor A. Herbert, Esq. (Alumax, Inc.).

[6] See July 14, 1979 letter from Norman Schou to Victor A. Herbert, Esq. In addition to granting no-action positions in connection with the sale of commercial paper when the proceeds are used for working capital purposes, including the construction of facilities, the Commission's staff has taken no-action positions when the proceeds are used to develop residential real estate for sale to prospective homebuyers. See letter dated November 1, 1980, from Norman Schou, Special Counsel, Division of Corporation Finance to David G. Ormsby, Cravath, Swaine & Moore (Olin-American, Inc.).

The commercial paper to be sold by the Bank, however, would be used specifically to construct a single facility. The tax-exempt commercial paper will be continually rolled-over until the facility is completed, at which time it will be paid off with the proceeds of a tax-exempt pollution control industrial development bond issue. It appears generally, therefore, that this type of tax-exempt obligation should be treated as a municipal security despite the fact that it matures in less than nine months.

Furthermore, the regulatory system applicable to municipal securities appears to be appropriate for these tax-exempt notes. They are exempted securities under Section 3(a)(2) of the Securities Act, and are apparently sold in the tax-exempt market without compliance with the Commission's registration or prospectus delivery requirements. Short-term promissory notes such as these may be viewed as investment alternatives by persons desiring tax-exempt income and sold in and traded in this market with other municipal securities. In 1975, Congress, recognizing the unique nature of the tax-exempt municipal markets, created a special regulatory system applicable to municipal securities.[7] Municipal commercial paper, including the tax-exempt notes which you have described, appears to be an increasingly large component of this tax-exempt municipal market and would appear to fall within the class of securities Congress sought to include within the municipal regulatory system. Accordingly, the tax-exempt notes should be treated as municipal securities.

Sincerely,
Thomas G. Lovett
Attorney

[7] In enacting the legislation creating this system, Congress created the Municipal Securities Rulemaking Board (the "MSRB") and directed it to adopt rules with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers. The MSRB has recognized that different types of securities are traded in the municipal market and adopted rules designed to accommodate these different securities. See, e.g., MSRB Rule A-13 (municipal underwriting assessment not applicable to securities with a stated maturity date of less than two years from the date of issue.) See also, MSRB, Notice dated January 22, 1981, concerning application of Board's rules to Municipal Assistance Corporation Warrants.

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Application of Board's Rules to Participation Interests in Municipal Tax-Exempt Financing Arrangements

In a recent letter to the Office of the Comptroller of the Currency, the staff of the Securities and Exchange Commission has taken the position that certain participation interests in tax-exempt installment sales contracts or lease purchase agreements are "municipal securities" as defined in the Securities Exchange Act of 1934, and, therefore, subject to the Board's rules. The Board believes that most of its rules will apply to these participation interests in the same way as they do to other kinds of municipal securities. The Board will continue to consider the application of its rules to participation interests and expects to publish further guidance on this matter within the near future. The Board would welcome the written comments of industry members and other interested persons concerning this subject.

The text of the Commission's letter follows. Questions concerning whether particular issues of participation interests in municipal tax-exempt financings are "municipal securities" should be directed to the Commission's Division of Market Regulation.

Comments or questions relating to this notice may be directed to Richard B. Nesson, General Counsel.

Securities and Exchange Commission
Washington, D.C. 20549

September 1, 1981

Owen Carney
Director
Investment Securities Division
Office of the Comptroller of the Currency
Washington, D.C. 20219

This is in response to your letter requesting our views concerning whether participation interests in tax-exempt financing arrangements such as installment sales contracts or lease purchase agreements ("tax-exempt leases" or "tax-exempt financing arrangements") are municipal securities within the meaning of Section 3(a)(29) of the Securities Exchange Act of 1934 (the "Act"). As an example of the type of security in which you are interested, you have referred specifically to a Master Equipment Lease (the "Lease") dated November 1, 1978, pursuant to which Tulsa County, Oklahoma as lessee ("Tulsa") agreed to purchase from Itel Corporation as lessor ("Itel") computer equipment to provide services for county and city departments and agencies. The Lease provides for a total purchase price of $1,539,914, with payment to be made over a 96-month period. Itel's interest in the Lease was fractionalized and sold to a number of investors by E.F. Hutton & Company, Inc. In the opinion of counsel for the transaction, the Lease represents a binding obligation of Tulsa, and, in addition, the interest portion of payments made pursuant to the Lease is exempt from federal income taxation.

The definition of municipal securities in Section 3(a)(29) of the Act includes:

> securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof. . . .

In determining whether participation interests in a tax-exempt lease are municipal securities, it is important first to determine whether the tax-exempt lease is a direct obligation of a state or political subdivision of a state ("municipality"), and second whether the participation interests in such a tax-exempt lease are also direct obligations of such a municipality.

Although the Act does not define the term "obligation" in connection with the definition of municipal security, it appears that the term as used in the definition of municipal security would generally include these instruments which are "obli-

[1] *See, e.g.*, letter dated May 10, 1978, from Anne E. Chafer, Attorney, Division of Market Regulation, to Mr. C.H. Watt of Bedford-Watt Enterprises. See also, H.R. Rep. No. 85, 73rd Cong., 1st Sess. 14 (1933) (Congress, in creating exemption from registration under Securities Act of 1933, attempted to cover generally those obligations exempted from federal income taxation).

gations" within the meaning of that term as it is used in Section 103 of the Internal Revenue Code (the "Code").[1] The exemption from federal income tax in Section 103 of the Code, which provides that "gross income does not include interest on the *obligations* of a state, . . . or any political subdivision [of a state] . . . . (emphasis added)," has been interpreted to apply to a number of different types of instruments. As a general matter, the exemption has not been limited to the interest on any particular form of obligation, but may also be "applicable to an ordinary written agreement of purchase and sale, in which the political subdivision agrees to pay interest."[2] In the context of a revenue ruling, the Internal Revenue Service (the "IRS") has enumerated a number of factors that are generally indicative of whether a specific transaction is a purchase and sale transaction, and therefore an obligation, rather than a standard commercial lease.[3] The IRS has subsequently, in private letter rulings, indicated that these factors may be applied to tax-exempt financing arrangements to determine if they are obligations.[4] As a general matter, tax-exempt leases that are structured to create "obligations" within the meaning of the Code would appear to constitute "obligations" within the definition of the municipal security. It appears that the Lease is such an obligation.

In addition to determining whether tax-exempt financing arrangements such as the Lease are obligations within the meaning of Section 3(a)(29), however, it is necessary to determine whether participation interests in such obligations are municipal securities. Although it is not possible to reach a conclusion with respect to all participation interests in tax-exempt financing arrangements, it appears that, as a general matter, such a participation interest would represent an obligation of a municipality if the financing arrangement were structured so that the holder of the participation interest looked primarily to the municipality as the source of payment.[5] Based upon this analysis, it appears that such participation interests, including the participation interests in the Lease, are also obligations as that term is used in the definition of municipal securities, and that such interests are municipal securities within the meaning of Section 3(a)(29) of the Act.[6]

Thomas G. Lovett
Attorney
Municipal Securities Branch

[1] *See, e.g.*, letter dated May 10, 1978, from Anne E. Chafer, Attorney, Division of Market Regulation, to Mr. C.H. Watt of Bedford-Watt Enterprises. See also, H.R. Rep. No. 85, 73rd Cong., 1st Sess. 14 (1933) (Congress, in creating exemption from registration under Securities Act of 1933, attempted to cover generally those obligations exempted from federal income taxation).

[2] *See Newlin Machinery Corporation*, 28 TC 837[1957 Transfer Binder] Stand. Fed. Tax Rep. (CCH)¶ 22,475. See also *Kings County Development Co.* v.*Commissioner*, 93 F.2d 33 (9th Cir. 1937), *cert. denied*, 304 U.S. 559 (1938).

[3] These factors include whether:
(a) portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee;
(b) the lessee will acquire title[to the property] upon the payment of a stated amount of rentals which under the contract he is required to make;
(c) the total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title;
(d) the agreed rental payments materially exceed the current fair rental value;
(e) the property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made; and
(f) some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.
Rev. Rul. 55-540, 1955-2 C.B. 39.

[4] *See, e.g.*, IRS letter ruling 7821068 (February 24, 1978). The IRS staff has indicated, however, it will no longer issue a ruling determining whether a particular agreement is a sale or lease. See, IRS private letter ruling 8115076 (January 16, 1981), referring to Revenue Procedure 80-22, 1980-1 C.B. 654.

[5] If the purchaser of the participation looks to someone other than the municipality for repayment, then the participation may represent a separate security, and an obligation of a person other than the municipality. *See, e.g.*, letters dated October 1, 1976, and December 8, 1976, from Consuela M. Washington, Attorney, Division of Corporation Finance, to Harvey B. Baum, Esq.; letter dated December 18, 1979, from Marcia L. MacHarg, Attorney, Division of Market Regulation, to Marcus M. Wasson, Esq., Andrews Mosbury Davis Blan Legg & Bixler, Inc.

[6] The Commission's Division of Corporation Finance has, in the past, granted no-action positions with respect to the registration provisions of the Securities Act for the sale of participation interests in tax-exempt financing arrangements. See letter dated January 7, 1977, from Consuela M. Washington, Attorney, Division of Corporation Finance, to Cyril V. Smith, Jr., Esq., Covington and Burling; letter dated June 4, 1976, from John Henegnan, Chief Counsel, Division of Corporation Finance to Gregory D. Erwin, Esq., Kutak, Rock, Cohen, Campbell, Garfinkle, & Woodward.