

File No. SR-MSRB-2002-14

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 19b-4
Proposed Rule Change
by

MUNICIPAL SECURITIES RULEMAKING BOARD

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

1. Text of Proposed Rule Change

(a) The Municipal Securities Rulemaking Board (the “MSRB”) is filing a proposed rule change consisting of an amendment to Rule A-4, on meetings of the Board, and an Interpretation of Rule G-17, on conduct of municipal securities activities (collectively referred to hereafter as the “proposed rule change”). The proposed rule change would provide a mechanism for halting trading of municipal securities by brokers, dealers and municipal securities dealers (collectively “dealers”) in the event of a catastrophic failure of market systems or infrastructure in the municipal securities market.

The text of the proposed rule change follows.¹

Rule G-17. Conduct of Municipal Securities Activities

Interpretation of Rule G-17 – Effecting Transactions During Market Emergency

It is inconsistent with the principles of fair dealing embodied in Rule G-17 for a broker, dealer or municipal securities dealer to effect transactions in municipal securities during a market emergency. For purposes of this interpretation, a market emergency is any situation causing a substantial failure in any of the systems necessary for clearance, settlement, confirmation, payment, or delivery of transactions in municipal securities or in other systems necessary for the prompt execution and consummation of municipal securities transactions or the fair and accurate pricing of municipal securities. In determining whether such a market emergency exists, a broker, dealer or municipal securities dealer shall rely upon the issuance of official announcements by the MSRB concerning market emergencies, which shall be issued after consultation with the Securities and Exchange Commission. Official announcements by the MSRB on market emergencies will be communicated to brokers, dealers and municipal securities dealers through news outlets commonly used in the municipal securities industry, by posting on the MSRB’s World Wide Web site at www.msrb.org, and by transmittal of the announcement to the electronic mail addresses provided to the MSRB by brokers, dealers and municipal securities dealers under Rule G-40. Such official announcements will include information on the nature of the market emergency and affected systems, the nature and scope of transactions affected, and the status of the market emergency and its expected duration, if that is known.

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Rule A-4. Meetings of the Board

(a) through (d) No change.

(e) Special Meetings on Market Emergencies. Notwithstanding anything in these rules to the contrary, the following procedures govern special meetings to act on market emergencies: (i) notice of a special telephone conference call meeting on a market

¹ Underlining indicates additions; strikethrough denotes deletions.

emergency shall be sent to all Board members by the Executive Director, or in the absence of the Executive Director, by his or her designee: (A) as soon as possible after credible information is received suggesting the existence of a market emergency, and (B) during the existence of a declared market emergency, within 24 hours of a request by any Board member; (ii) notice of a special meeting on a market emergency, including a description of the proposed Board action and instructions for joining the conference call, shall be given by telephone and by e-mail to all Board members; (iii) the Executive Director, or his or her designee, shall consult with the Commission on the emergency situation prior to a special meeting on a market emergency, if possible; (iv) the quorum requirement for a special meeting on a market emergency shall be five members and there shall be no requirement that at least one public representative, one broker-dealer representative and one bank representative be present; and (v) any action taken at such a meeting shall be by a majority vote of Board members attending the meeting and shall be limited to declaring a market emergency or ending a declared market emergency. For purposes of this paragraph (e), the meaning of the term “market emergency” shall be as defined in “Notice of Interpretation of Rule G-17 – Effecting Transactions During Market Emergency,” dated _____.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-regulatory Organization

The MSRB at its November 14-15, 2002 meeting adopted the proposed rule change. Questions concerning this filing may be directed to Justin R. Pica, Uniform Practice Specialist, at 703-797-6600.

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

(a) After the events of September 11, 2001, staff of the Securities and Exchange Commission (“Commission”) and the MSRB met to discuss how the municipal securities market functioned in the aftermath of the attacks on the World Trade Center. On September 11, and in days following, MSRB monitored the municipal securities market through its contacts with dealers, clearing corporations and information providers.

Although the effect on lower Manhattan was severe, because the municipal securities market is decentralized, the municipal securities market as a whole was not affected to the same degree as securities exchanges physically located near the disaster. On September 11, some trading in municipal securities occurred, albeit a very limited amount. Based on transactions reported to the MSRB’s Transaction Reporting System, trade volume reached 8,244 trades by September 13 and 17,941 trades by September 17. On September 19 and 20 transaction volume reached 23,996 and 26,155 trades respectively. Prior to September 11, in a typical day, 27,000 transactions were processed.

Aside from dealer operations in Manhattan, in general, the infrastructure and systems necessary for processing transactions in the municipal securities market functioned in the days after September 11. Clearance and settlement systems for municipal securities transactions provided by Depository Trust and Clearing Corporation (DTCC) remained operational, although telecommunications problems in Manhattan did affect the ability of dealers in that area to exchange data with DTCC. The problems with clearing bank functions that disrupted the government securities market did not substantially affect the municipal securities market.

Despite the resilience of municipal securities market systems and infrastructure on September 11, there remains a concern about what might have happened if the situation had been different. Had systems or infrastructure critical to the municipal securities market been disabled by the disaster, no legal or regulatory mechanism existed to temporarily halt trading. For example, any problems with central clearance and settlement systems are of an immediate concern, since the accumulation of unsettled trades, particularly in a volatile or chaotic market, presents risks to all segments of the market. Commission staff accordingly have asked MSRB to consider rulemaking to provide a procedure for a trading halt should a market emergency disable critical market systems or infrastructure in the future.

The proposed rule change would provide such a procedure. Should a similar situation occur in the future, MSRB would review conditions in the market through its contacts with dealers, clearing agencies and vendors of critical services to the market just as it did after September 11. The proposed rule change, however, includes changes to MSRB's administrative procedures in Rule A-4 allowing special MSRB telephone conference call Board meetings on market emergencies to occur without the normal notice requirement of seven days or the normal quorum requirement of two-thirds of the Board's members. The proposed rule change also includes a formal interpretation of Rule G-17, on fair practice, that would prohibit dealers from trading for the duration of a market emergency declared by the MSRB. These proposed rule changes thus provide a procedure for instituting a trading halt should a market emergency necessitate one in the future.

The proposed rule change specifically identifies the channels by which MSRB would make information known to municipal securities dealers in the event of a market emergency. It notes that this will be done through news outlets commonly used in the municipal securities industry, postings on the MSRB's web site and by transmitting announcements to the electronic mail addresses provided to the MSRB by dealers under Rule G-40, on electronic mail contacts. Having an announced, written procedure for dealer notification would add a level of preparedness if a market emergency actually occurs. Just as important, it provides dealers with clear direction on where to look if the situation is uncertain and questions exist about whether an emergency has been declared. This also will help dealers determine if any other emergency rulemaking is in effect. After September 11 there was some confusion among municipal securities dealers about whether the regular-way settlement cycle for municipal securities had been changed to T+5 from the T+3 cycle mandated under MSRB Rules G-12(b)(ii) and G-15(b)(ii). This

apparently was the result of announcements made concerning transactions in government bonds. In monitoring clearance and settlement data after September 11, the MSRB observed that some dealers were, as a practice, submitting all of their regular-way trades with a T+5 settlement date. Among other problems, this caused trade-matching failures in the central comparison system for inter-dealer transactions. The notification procedure for market emergency declaration will help direct the attention of dealers in municipal securities to the MSRB for announcements on possible rule changes in the wake of an emergency and thus should help to avoid similar confusion in the future.²

The proposed rule change's Interpretation of Rule G-17 follows a principle of securities law that a dealer must not "accept or execute any order for the purchase or sale of securities or induce or attempt to induce such purchase or sale if the dealer does not have the personnel and facilities to enable prompt execution and consummation the transactions."³ The MSRB believes that, where a substantial failure has occurred in the systems necessary for clearance, settlement, confirmation, payment or delivery of transactions in municipal securities, or in other systems necessary for the prompt execution and consummation of municipal securities transactions or the fair and accurate pricing of municipal securities, it may become necessary, for the overall protection of market participants, to halt trading by all dealers.⁴ Clearance and settlement systems are a particular concern because of counter-party risk that escalates when unsettled transactions grow during volatile or chaotic markets. Other situations possibly warranting a temporary halt in trading might include a massive failure of telecommunication systems, or the corruption of essential data used by the municipal securities industry (for example, through a computer virus).

Interpretation of Rule G-17

The proposed Interpretation of Rule G-17 has the following elements:

² The proposed rule change addresses only the procedure for announcing trading halts. Should changes in existing MSRB rules be necessary during an emergency, these could be adopted by the MSRB and approved summarily by the SEC. Section 19(b)(3)(B) of the Securities Exchange Act grants the SEC authority to approve proposed rule changes summarily when "it appears to the Commission that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds."

³ See, e.g., Securities Exchange Act Release No. 8363 (July 29, 1968), 33 FR 11150 (August 7, 1968).

⁴ The scope of the proposed rule change does not include the issuance of "regulatory halts" similar to those issued by exchanges and other SROs to stop trading in a specific security pending the announcement of news, or to allow news to be absorbed by the market before trading continues. Since this situation would not constitute an emergency effecting essential systems and market infrastructure, it is not included within the definition of a market emergency.

- It is a violation of Rule G-17 for a dealer to continue to effect transactions in municipal securities during an MSRB-declared “market emergency.”
- A “market emergency” for this purpose is defined as “a situation causing substantial failure in any of the systems necessary for clearance, settlement, confirmation, payment or delivery of transactions in municipal securities, or in other systems necessary for the prompt execution and consummation of municipal securities transactions or the fair and accurate pricing of municipal securities.”
- Prior to acting on a market emergency, MSRB will consult with the SEC.
- Official announcements by the MSRB on market emergencies will be communicated to dealers through news outlets commonly used in the municipal securities industry, by posting on the MSRB’s World Wide Web site at www.msrb.org, and by transmittal of the announcement to the electronic mail addresses provided to the MSRB by dealers under Rule G-40.

Amendment to Rule A-4

Prior to making any decision on a specific market emergency, the MSRB will hold a special Board meeting to share information and discuss the situation. The MSRB’s current procedure for holding special Board meetings is contained in Rule A-4. Among other provisions, the rule states that the Secretary of the Board will call special meetings at the request of the Chairman or at the written request of three or more members. Seven days written notice, signed by the Secretary of the Board (or three days notice if given or sent by telephone, e-mail or personal delivery), is required for special meetings. The quorum for any Board meeting is two-thirds of the Board (normally ten members), with at least one securities firm representative, one bank dealer representative and one public member. Formal action requires an affirmative vote of the majority of the Board (normally eight members).

During a time of crisis, market participants would want to know fairly quickly whether trading is to be halted. The existing seven-day and three-day notice requirements for special Board meetings thus seem impractical. Moreover, establishing communication with at least ten Board members and securing eight affirmative votes also might present a problem, particularly if the emergency in question affects the infrastructure of one or more major financial centers and members cannot be reached. The proposed rule change would streamline the process specifically for market emergency meetings. The proposed amendment to Rule A-4 provides the following procedure:

- The Executive Director, or his or her designee, will schedule a special telephone conference call meeting on the possible declaration of a market emergency as quickly as possible after receipt of credible evidence that a market emergency exists.

- At least one hour's advance notice of a special meeting on a market emergency will be sent to each Board member by telephone and e-mail.
- The Executive Director, or his or her designee, will consult with the SEC prior to each special meeting if this is possible. (Note that consultation with SEC would be required by the interpretation of Rule G-17 governing trading halts. Thus, consultation with the SEC would have to occur prior to any formal declaration of market emergency even if it does not occur prior to the meeting.)
- The quorum of ten members generally necessary for a Board meeting is replaced for special meetings on market emergencies with a quorum of five members. The general requirement that a member be present from each of the three statutory categories (securities firm, bank dealer, public member) does not apply.
- The requirement in the proposed rule change that all Board members be sent a notice of the special meeting by both telephone and e-mail is to ensure that as many Board members as possible, including those from all three statutory categories, can be included in the meeting. While the five-person quorum requirement does not contain any distributional requirements, Board staff shall endeavor, to the extent circumstances permit, to have at least one broker-dealer, one bank, and one issuer representative at the special meetings. To that end, Board staff shall obtain from each Board member contact information that will help ensure the ability of the staff to get notice of a special meeting to such persons in market emergency situations.
- Board action at a meeting on a market emergency is limited to declaring a market emergency or ending a declared market emergency.
- A majority vote of members attending the meeting (not necessarily a majority of the Board) is required to take action.
- Once a market emergency has been declared, the Executive Director, or his or her designee, will schedule additional special conference call meetings on the market emergency within 24 hours after any request to do so by a Board member.

(b) The MSRB believes the proposed rule change is consistent with Section 15B(b)(2)(C) of the Securities Exchange Act of 1934, which provides that MSRB rules shall:

... be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade ... and, in general, to protect investors and the public interest

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

The MSRB does not believe that the proposed rule change will impose any burden on competition among dealers in that it applies equally to all dealers in municipal securities.

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

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

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

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

Not applicable.

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

Not applicable.

9. Exhibits

1. Notice for Federal Register