MSRB
REPORTS

Volume 2, Number 5 | Municipal Securities Rulemaking Board | July 1982

Five Board Members Elected to Three-Year Terms

The Board is pleased to announce the election of five Board members to serve three-year terms beginning October 1, 1982. The individuals chosen by the Board are:

John L. Glenn, Jr.—senior vice president of Sun Bank and a member of the Dealer Bank Association.

Arch W. Roberts—founder and president of Arch W. Roberts & Co. and member of the Board of Directors of the Public Securities Association.

Donald J. Robinson—a partner with the law firm of Hawkins, Delafield and Wood. Mr. Robinson was previously elected to the Board to fill the seat vacated by James V. Young who resigned in 1981.

Everett D. Williams—a partner with Stone and Youngberg, served on the Board of Directors of the Public Securities Association.

Frederick C. Witsell, Jr.—senior vice president of Morgan Guaranty Trust Co. and a former chairman of the Dealer Bank Association's Public Finance Committee.

In This Issue

June–August

June 18 —amendment to rule A-3 approved revising procedure for succession of Board members

July 10 —comments were due regarding applicability of rules G-11, G-15 and G-17 to municipal lease and installment contract participations

August 1—new effective date for rule G-33 on calculations

Pending —SEC approval of amendments to rule G-12 (facilitating clearing through registered clearing agencies)

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MSRB REPORTS

Volume 2, Number 5 July 1982

Notice of Approval

Route To:

- ☒ Manager, Muni. Dept.
- ☐ Underwriting
- ☐ Trading
- ☐ Sales
- ☒ Operations
- ☒ Compliance
- ☐ Training
- ☐ Other________

Rule G-33

Amendments to Calculations Rule Approved

On June 22, 1982 the Securities and Exchange Commission approved certain technical amendments to Board rule G-33 on calculations. The rule prescribes formulas for the computation of accrued interest, dollar price, and yield on municipal securities transactions, and sets standards in other related areas. The amendments approved by the Commission effect the following changes to the rule:

- The amendments correct an error regarding the assumptions stated in the rule concerning the values of certain of the symbols used in the day counting formula when computing a day count for a period beginning or ending on the 31st of a month. The rule as amended accords with accepted industry practice.
- The amendments clarify that the day counting formula provided in the rule is to be used only for day counts on a "30/360" day basis.
- The amendments revise certain of the formulas to permit computation of a dollar price or a yield to a premium call feature on transactions in callable municipal notes.
- The amendments clarify the use of all of the formulas in determining a dollar price or a yield to a premium call, par option, or tender option feature. The more general term "redemption" has been substituted, where appropriate, for the term "maturity," and certain of the symbols have been redesignated in accordance with this change. The term "redemption" should be understood to encompass redemption at maturity, as well as redemption by virtue of a premium call, par option, or tender option feature.
- The amendments slightly modify certain of the formulas to substitute a subtraction term for the symbol designating the period from the transaction settlement date to the interest payment date. This will prevent the use of inaccurate day counts on transactions settling on the 31st of a month.
- The amendments also make other technical changes to clarify the types of securities to which certain formulas relate, and to make certain of the definitions of the symbols more precise.

The provisions of rule G-33 will become effective on August 1, 1982, except as provided in the rule.*

June 25, 1982

Questions on rule G-33 may be directed to Donald F. Donahue, Deputy Executive Director

Text of Rule

Rule G-33

(a)Accrued Interest. Accrued interest shall be computed in accordance with the following formula:

$$\text{Interest} = \text{Rate} \times \frac{\text{Par Value of}}{\text{Transaction}} \times \frac{\text{Number of Days}}{\text{Number of Days in Year}}$$

For purposes of this formula, the "number of days" shall be deemed to be the number of days from the previous interest payment date (from the dated date, in the case of first coupons) up to, but not including, the settlement date. The "number of days" and the "number of days in year" shall be counted in accordance with the requirements of section (e) below.

(b) Interest-Bearing Securities

(i) Dollar Price. For transactions in interest-bearing securities effected on the basis of yield the resulting dollar price shall be computed in accordance with the following provisions:

(A) Securities Paying Interest Solely at Redemption. Except as otherwise provided in this section (b), the dollar price for a transaction in a security paying interest solely at redemption shall be computed in accordance with the following formula:

$$P = \left[\frac{RV + \left(\frac{DIR}{B} * R\right)}{1 + \left(\frac{DIR - A}{B} * Y\right)}\right] - \left[\frac{A}{B} * R\right]$$

For purposes of this formula the symbols shall be defined as follows:

"A" is the number of accrued days from the beginning of the interest payment period to the settlement date (computed in accordance with the provisions of section (e) below);

"B" is the number of days in the year (computed in accordance with the provisions of section (e) below);

*Certain provisions of the rule, regarding the use of dollar price interpolation and the computation of dollar price on a transaction at a yield price equal to the interest rate of the securities, are not scheduled to become effective until January 1, 1984.

"DIR" is the number of days from the issue date to the redemption date (computed in accordance with the provisions of section (e) below);
"P" is the dollar price of the security for each $100 par value (divided by 100);
"R" is the annual interest rate (expressed as a decimal);
"RV" is the redemption value of the security per $100 par value (divided by 100); and
"Y" is the yield price of the transaction (expressed as a decimal).

(B) Securities with Periodic Interest Payments. Except as otherwise provided in this section (b), the dollar price for a transaction in a security with periodic interest payments shall be computed as follows:

(1) for securities with six months or less to redemption, the following formula shall be used:

$$P = \left[\frac{\frac{RV}{100} + \frac{R}{M}}{1 + \left(\frac{E-A}{E} * \frac{Y}{M} \right)} \right] - \left[\frac{A}{B} * R \right]$$

For purposes of this formula the symbols shall be defined as follows:
"A" is the number of accrued days from the beginning of the interest payment period to the settlement date (computed in accordance with the provisions of section (e) below);
"B" is the number of days in the year (computed in accordance with the provisions of section (e) below);
"E" is the number of days in the interest payment period in which the settlement date falls (computed in accordance with the provisions of section (e) below);
"M" is the number of interest payment periods per year standard for the security involved in the transaction;
"P" is the dollar price of the security for each $100 par value (divided by 100);
"R" is the annual interest rate (expressed as a decimal);
"RV" is the redemption value of the security per $100 par value; and
"Y" is the yield price of the transaction (expressed as a decimal).

(2) for securities with more than six months to redemption, the following formula shall be used:

$$P = \left[\frac{RV}{\left(1 + \frac{Y}{2}\right)_{exp} N - 1 + \frac{E-A}{E}} \right] + \left[\sum_{K=1}^{N} \frac{100 * \frac{R}{2}}{\left(1 + \frac{Y}{2}\right)_{exp} K - 1 + \frac{E-A}{E}} \right] - \left[100 * \frac{A}{B} * R \right]$$

For purposes of this formula the symbols shall be defined as follows:
"A" is the number of accrued days from beginning of the interest payment period to the settlement date (computed in accordance with the provisions of section (e) below);
"B" is the number of days in the year (computed in accordance with the provisions of section (e) below;
"E" is the number of days in the interest payment period in which the settlement date falls (computed in accordance with the provisions of section (e) below);
"N" is the number of interest payments (expressed as a whole number) occurring between the settlement date and the redemption date, including the payment on the redemption date;
"P" is the dollar price of the security for each $100 par value;
"R" is the annual interest rate (expressed as a decimal);
"RV" is the redemption value of the security per $100 par value; and
"Y" is the yield price of the transaction (expressed as a decimal).
For purposes of this formula the symbol "exp" shall signify that the preceding value shall be raised to the power indicated by the succeeding value; for purposes of this formula the symbol "K" shall signify successively each whole number from "1" to "N" inclusive; for purposes of this formula the symbol "sigma" shall signify that the succeeding term shall be computed for each value "K" and that the results of such computations shall be summed.

(C) Transactions Where the Yield Equals the Interest Rate. A transaction in a security with a redemption value of par that is effected on the basis of a yield price equal to the interest rate of the security shall be exempt from the requirements of subparagraph (b)(i)(B) until January 1, 1984.

(D) Interpolation. The computation of a dollar price by means of interpolation shall be deemed to be in compliance with this paragraph (b) (i) until January 1, 1984.

(ii) Yield. Yields on interest-bearing securities shall be computed in accordance with the following provisions:

(A) Securities Paying Interest Solely at Redemption. The yield of a transaction in a security paying interest solely at redemption shall be computed in accordance with the following formula:

$$Y = \left[\frac{\left(RV + \left(\frac{DIR}{B}\ R\right)\right) - \left(P + \left(\frac{A}{B} * R\right)\right)}{P + \left(\frac{A}{B} * R\right)} \right] * \left[\frac{B}{DIR - A} \right]$$

For purposes of this formula the symbols shall be defined as follows:
"A" is the number of accrued days from the beginning of the interest payment period to the settlement date (computed in accordance with the provisions of section (e) below);

"B" is the number of days in the year (computed in accordance with the provisions of section (e) below);
"DIR" is the number of days from the issue date to the redemption date (computed in accordance with the provisions of section (e) below);
"P" is the dollar price of the security for each \$100 par value (divided by 100);
"R" is the annual interest rate (expressed as a decimal);
"RV" is the redemption value of the security per \$100 par value (divided by 100); and
"Y" is the yield on the investment if the security is held to redemption (expressed as a decimal).

(B) Securities with Periodic Interest Payments. The yield of a transaction in a security with periodic interest payments shall be computed as follows:

(1) for securities with six months or less to redemption, the following formula shall be used:

$$Y = \left[\frac{\left(\frac{RV}{100} + \frac{R}{M}\right) - \left(P + \left(\frac{A}{E} * \frac{R}{M}\right)\right)}{P + \left(\frac{A}{E} * \frac{R}{M}\right)} \right] * \left[\frac{M * E}{E - A}\right]$$

For purposes of this formula the symbols shall be defined as follows:
"A" is the number of accrued days from the beginning of the interest payment period to the settlement date (computed in accordance with the provisions of section (e) below;
"E" is the number of days in the interest payment period in which the settlement date falls (computed in accordance with the provisions of section (e) below);
"M" is the number of interest payment periods per year standard for the security involved in the transaction;
"P" is the dollar price of the security for each \$100 par value (divided by 100);
"R" is the annual interest rate (expressed as decimal);
"RV" is the redemption value of the security per \$100 par value; and
"Y" is the yield on the investment if the security is held to redemption (expressed as a decimal).

(2) for securities with more than six months to redemption the formula set forth in item (2) of subparagraph (b)(i)(B) shall be used.

(c) Discounted Securities.

(i) Dollar Price. For transactions in discounted securities, the dollar price shall be computed in accordance with the following provisions:

(A) The dollar price of a discounted security, other than a discounted security traded on a yield-equivalent basis, shall be computed in accordance with the following formula:

$$P = \left[RV\right] - \left[DR * RV * \frac{DSM}{B}\right]$$

For purposes of this formula the symbols shall be defined as follows:
"B" is the number of days in the year (computed in accordance with the provisions of section (e) below);
"DR" is the discount rate (expressed as a decimal);
"DSM" is the number of days from the settlement date of the transaction to the maturity date (computed in accordance with the provisions of section (e) below);
"P" is the dollar price of the security for each \$100 par value; and
"RV" is the redemption value of the security per \$100 par value.

(B) The dollar price of a discounted security traded on a yield-equivalent basis shall be computed in accordance with the formula set forth in subparagraph (b)(i)(A).

(ii) Return on Investment. The return on investment for a discounted security shall be computed in accordance with the following provisions:

(A) The return on investment for a discounted security, other than a discounted security traded on a yield-equivalent basis, shall be computed in accordance with the following formula:

$$IR = \left[\frac{RV - P}{P}\right] * \left[\frac{B}{DSM}\right]$$

For purposes of this formula the symbols shall be defined as follows:
"B" is the number of days in the year (computed in accordance with the provisions of section (e) below);
"DSM" is the number of days from the settlement date of the transaction to the maturity date (computed in accordance with the provisions of section (e) below);
"IR" is the annual return on investment if the security is held to maturity (expressed as a decimal);
"P" is the dollar price of the security for each \$100 par value; and
"RV" is the redemption value of the security per \$100 par value.

(B) The yield of a discounted security traded on a yield-equivalent basis shall be computed in accordance with the formula set forth in subparagraph (b)(ii)(A).

(d) Standards of Accuracy; Truncation.

(i) Intermediate Values. All values used in computations of accrued interest, yield, and dollar price shall be computed to not less than ten decimal places.

(ii) Results of Computations. Results of computations shall be presented in accordance with the following:

(A) Accrued interest shall be truncated to three decimal places, and rounded to two decimal places immediately prior to presentation of total accrued interest amount on the confirmation;

(B) Dollar prices shall be truncated to three decimal places immediately prior to presentation of dollar price on the confirmation and computation of extended principal; and

(C) Yields shall be truncated to four decimal places, and rounded to three decimal places, provided, however, that for purposes of confirmation display as required under rule G-15(a)(viii)(B) yields accurate to the nearest .05 percentage points shall be deemed satisfactory.

Numbers shall be rounded, where required, in the following manner: if the last digit after truncation is five or above, the preceding digit shall be increased to the next highest number, and the last digit shall be discarded.

(e) Day Counting.

(i) Day Count Basis. Computations under the requirements of this rule shall be made on the basis of a thirty-day month and a three-hundred-sixty-day year, or, in the case of computations on securities paying interest solely at redemption, on the day count basis selected by the issuer of the securities.

(ii) Day Count Formula. For purposes of this rule, computations of day counts on the basis of a thirty-day month and a three-hundred-sixty-day year shall be made in accordance with the following formula:

$$\text{Number of Days} = (Y2-Y1)\,360 + (M2-M1)\,30 + (D2-D1)$$

For purposes of this formula the symbols shall be defined as follows:

"M1" is the month of the date on which the computation period begins;

"D1" is the day of the date on which the computation period begins;

"Y1" is the year of the date on which the computation period begins;

"M2" is the month of the date on which the computation period ends;

"D2" is the day of the date on which the computation period ends; and

"Y2" is the year of the date on which the computation period ends.

For purposes of this formula, if the symbol "D2" has a value of "31", and the symbol "D1" has a value of "30" or "31", the value of the symbol "D2" shall be changed to "30". If the symbol "D1" has a value of "31", the value of the symbol "D1" shall be changed to "30". For purposes of this rule time periods shall be computed to include the day specified in the rule for the beginning of the period but not to include the day specified for the end of the period.

(f) Effectiveness. The requirements of this rule shall become effective on August 1, 1982, except as provided in subparagraphs (C) and (D) of paragraph (b)(i).

MSRB REPORTS

Volume 2, Number 5 July 1982

Route To:

- [x] Manager, Muni. Dept.
- [x] Underwriting
- [ ] Trading
- [ ] Sales
- [ ] Operations
- [ ] Compliance
- [ ] Training
- [ ] Other______

Rule G-11

Notice Concerning Board Determination Not to Adopt Concession Rules

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

During the summer of 1981 the Board considered a request from the Public Securities Association ("PSA") that it determine the extent of its jurisdiction to adopt rules governing the granting of concessions in new issues of municipal securities. The Board was also asked to consider the appropriateness of amending rule G-11, regarding syndicate practices, to set forth to whom and under what circumstances concessions from public offering prices might be made available. After considering this matter in depth, the Board concluded that while rules regarding the granting of concessions to customers are within the scope of Board rulemaking authority under the Securities Exchange Act of 1934 ("Exchange Act"), it did not believe that such rules were necessary or appropriate.[1] The Board's letter of response to the PSA pointed out that in deciding not to adopt concession rules the Board had considered the manner in which new issue municipal securities are distributed by syndicates, whether the additional regulatory restraints on syndicate practices which would be imposed by such concession rules are necessary for the maintenance of the current distribution system, and whether concession rules would have anti-competitive effects not necessary or appropriate to further the purposes of the Exchange Act.[2] Recent industry discussions of the Board's decision suggest the need for some further explanation of that decision. This notice also responds to inquiries which the Board has received from members of the industry asking whether, in light of the Board's determination not to adopt concession rules, there are any regulations which restrict the granting of concessions by municipal securities syndicates or municipal securities dealers to customers.

Scope of the Board's Authority

Section 15B(b)(2)(K) of the Exchange Act authorizes the Board to adopt rules to

> establish the terms and conditions under which any municipal securities dealer may sell, or prohibit any municipal securities dealer from selling, any part of a new issue of municipal securities to a municipal securities investment portfolio during the underwriting period.

Section 15A(e)(3) of the Act makes it clear that rules adopted by the Board pursuant to Section 15B(b)(2)(K) may address the subject of concessions.[3]

In addition, section 15B(b)(2)(C) of the Exchange Act authorizes the Board to adopt rules with respect to transactions in municipal securities which, among other things, are

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

Under similar statutory authority concerning corporate securities, the National Association of Securities Dealers, Inc. ("NASD") has adopted certain amendments to its fair practice rules which enforce fixed-price offering agreements, as discussed more fully below.[4]

While the adoption of rules restricting the granting of concessions in new issue municipal securities is within the scope of the Board's rulemaking authority, it should be noted that the Exchange Act also imposes a number of conditions on the exercise of that authority. Section 15B(b)(2)(C) of the Act provides that the Board's rules shall

[1] The PSA's letter and the Board's response, which were previously reprinted in *MSRB Reports*, Volume 1, Number 4 (November 1981), are attached to this notice.

[2] The United States Supreme Court has indicated that actions of self-regulatory organizations, such as the Board, are immunized from the antitrust laws "only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." *Silver v. New York Stock Exchange,* 373 U.S. 341, 357 (1963).

[3] Section 15A(e)(3) provides in part that the granting of concessions between members of the NASD and bank dealers shall be subject to rules adopted by the Municipal Securities Rulemaking Board, if any.

[4] *See* Section 15A(b)(6) of the Exchange Act.

> not be designed to permit unfair discrimination between customers, issuers, municipal securities brokers, or municipal securities dealers, to fix minimum profits, to impose any schedule or fix rates of commission, allowances, discounts, or other fees to be charged by municipal securities brokers or municipal securities dealers, . . . or to impose any burden on competition not necessary or appropriate in furtherance of the purpose of [the Exchange Act].

Thus, for example, a rule which would require syndicate members to enter into fixed-price offering agreements for the distribution of new issue municipal securities, may be deemed to violate the Act's prohibition against rules which impose a price schedule or fix discounts.

The Board has considered whether Board rules enforcing the terms of fixed-price offering agreements which syndicate members voluntarily enter into are necessary and appropriate for the municipal securities industry. In addressing these questions the Board reviewed the regulatory pattern which has been developed by the NASD to preserve the fixed-price system for distributing corporate securities. In particular, the Board carefully considered the opinion rendered by the Securities and Exchange Commission at the time it approved a package of rule proposals submitted by the NASD which have come to be known as the "Papilsky" rules.[5]

SEC Approval of NASD "Papilsky" Rules

The "Papilsky" rules apply to fixed-price offerings of corporate securities and expressly (1) prohibit syndicate members from granting to selected retail customers discounts from the stated public offering price; (2) prohibit the practice of overtrading (*i.e.,* selling new issue securities to a customer who pays for them with securities having a market value below the price at which the syndicate "takes them in trade"); and, (3) prohibit a syndicate member from selling new issue corporate securities to a related portfolio.

It is important to note that the "Papilsky" rules supplemented a long-standing system of NASD regulation which reinforces corporate fixed-price offerings.[6] Other NASD rules, for example, require that syndicate members make bona fide public distributions at the public offering price and prohibit "free-riding" and "withholding."[7]

The Commission's opinion discussed at length whether the anti-competitive effects of the "Papilsky" rules were necessary and appropriate to achieve the purposes of the Exchange Act. In resolving this issue, the Commission appeared to place great weight on the following factors: (1) the fix-price offering system traditionally had been the primary means of distributing new issue corporate securities; (2) the NASD's existing regulatory framework supported that system; and (3) failure to supplement the existing regulatory framework could adversely affect the fixed-price offering system, thereby disrupting the capital formation process.[8]

The kind of fixed-price offering system developed for corporate securities has not been the primary means of distributing municipal securities. Further, as indicated in the Board's letter to the PSA, in light of the fact that the system for distributing municipal securities has appeared to function efficiently without regulations of the type described above, the Board questions whether the effects of such regulations in restraining prices of new issue municipal securities could be justified as necessary and appropriate.

Possible Restrictions on Municipal Syndicate Practices

In adopting rule G-11, the Board chose to require the disclosure of practices adopted by syndicates rather than dictate what those practices must be.[9] The disclosure provisions of the rule are intended to provide to participants in the new issue market information that will enable them to understand and evaluate syndicate practices and to lessen the disparity in information between the manager and other members of the syndicate. The rule, however, allows municipal syndicates maximum flexibility in selecting procedures most appropriate to their own requirements.

In order to assure that any Board rules restricting the granting of concessions to customers would apply equally to all customers and would be enforceable, such rules would have to contain provisions which limit the flexibility of syndicate members, similar to those adopted by the NASD for corporate securities. The NASD's rule which is intended to prohibit overtrading in swap transactions, for example, imposes detailed recordkeeping requirements on syndicate members and contains a number of presumptions and standards to apply in determining when swap transactions are permissible. Any Board concession rules would also, at a minimum, have to restrict the ability of related portfolios of bank dealers and bond funds to obtain the concession.[10] The Board is concerned that such restrictions would not only limit syndicate flexibility but could adversely affect the market for new issue municipal securities.

Non-Existence of Other Customer Concession Rules

The Board knows of no laws or regulations which purport to restrict the granting of concessions by municipal securities syndicates or municipal securities dealers to custom-

[5]Securities Exchange Act Rel. No. 17371, 45 Fed Reg 83707 (Dec. 19, 1980).

[6]As the Commission's opinion points out, Section 24 of the NASD's Rules of Fair Practice, which imposes restrictions on underwriting and selling concessions, was adopted by the NASD in 1939, the year the NASD was established.

[7]The NASD's "free-riding" and "withholding" interpretation provides that an NASD member's failure to make a bona fide public distribution at the public offering price of securities which immediately trade at a premium in the secondary market constitutes a violation of the NASD's Rules of Fair Practice. The interpretation lists a series of prohibited transactions including the sale of such securities to persons having certain personal or commercial relationships to the member as well as a member's continued holding of such securities in its own account.

[8]The Commission's opinion indicated that it had also considered the fact that issuers, underwriters and institutional investors all seemed to support the corporate fixed-price offering system.

[9]In formulating rule G-11, the Board initially considered a series of proposals in the form of exposure drafts which would have regulated sales of new issue municipal securities, including proposals prescribing a bona fide offering period and restricting sales to related portfolios and bond funds. In part, concerns which were expressed by many industry commentators that the proposed regulations could unnecessarily restrict prices and increase the borrowing costs for municipal issuers caused the Board to reject these proposals.

[10]As discussed above, one of the "Papilsky" rules, Section 36 of the NASD's Rules of Fair Practice, prohibits sales of new issue corporate securities by syndicate members to their related portfolios.

ers.[11] As indicated above, the NASD's customer concession rules apply to fixed-price offerings in corporate securities and, by their terms, do not apply to transactions in municipal securities.[12]

June 25, 1982

Response to PSA Request that MSRB Consider Adoption of Concession Rules

May 12, 1981

Mr. Albert F. Blaylock
Chairman
Municipal Securities Rulemaking Board
1150 Connecticut Avenue, N.W.
Washington, D.C. 20036

Dear Al:

At its recent meeting, the PSA Board voted to request the MSRB to give consideration to the subject of the granting of concessions in new issues of municipal securities. Traditionally, concessions had been made available only to other professional dealers and dealer banks. In recent years there has been a growing tendency on the part of some underwriters to give concessions to certain institutional or other clients. Because there has been no consistent practice or rule in this area, many dealers and dealer banks believe that the present situation has led to less orderly marketing of new issue municipal securities, inequities in price to various classes of investors, and increased costs to issuers.

Therefore, we ask that the MSRB address this matter, determing the extent of its jurisdiction in this area and the appropriateness of amending its syndicate rule (G-11) to address specifically the question of to whom and under what circumstances concessions from public offering prices might be made available.

The Syndicate and Trading Committee of PSA's Municipal Securities Division has been requested by our Board to consider possible approaches in this matter, and to report its recommendations for further consideration.

With the apparent clarification of the Papilsky matter, PSA believes this is an appropriate time to open discussion of this important question.

Sincerely

Peter C. Trent
Chairman
Public Securities Association

* * * * *

September 25, 1981

Peter C. Trent
Chairman
Public Securities Association
One World Trade Center
New York, New York 10048

Dear Peter:

This is in response to your May 12, 1981, letter asking the Board to consider the extent of its jurisdiction to adopt rules governing the granting of concessions in new issues of municipal securities and the appropriateness of amending rule G-11, regarding syndicate practices, to set forth to whom and under what circumstances concessions from public offering prices might be made available.

The Municipal Securities Rulemaking Board has the authority under Section 15B of the Securities Exchange Act to adopt rules regarding the granting of concessions to customers by syndicate members in fixed-price offerings of new issue securities. Notwithstanding that fact, the Board does not believe that such an amendment of rule G-11 is necessary or appropriate at this time. In adopting rule G-11, the Board chose to require the disclosure of syndicate practices adopted by the syndicate rather than dictate what those practices must be. The rule permits municipal syndicates maximum flexibility in selecting procedures most appropriate to their own requirements. The Board believes that adoption of provisions regarding the granting of concessions is within a syndicate's rulemaking province and is not convinced that efforts in this respect have been exhausted.

Thus, the Board has concluded that syndicate flexibility should not be circumscribed at this time by the adoption of concession rules. In addition to the above, the Board based its determination upon the manner in which new issue municipal securities are distributed by syndicates; whether additional regulatory restraints on syndicate practices are necessary for the maintenance of the current distribution system, and, whether such additional regulation would have anticompetitive effects not necessary or appropriate.

While the Board is not adopting concession rules at this time, it will monitor closely developments in the new issue industry and will consider carefully any information brought to its attention regarding the need for such rules.

Sincerely,

Albert F. Blaylock
Chairman

[11]Section 25 of the NASD's Rules of Fair Practice prohibits NASD members from granting concessions in municipal securities transactions to non-member brokers and dealers (other than bank dealers).

[12]*See* NASD Rules of Fair Practice, Article II, Section 1, Subsection (m) and Special Notice to NASD Members, No. 81-3 (February 9 1981).

MSRB
REPORTS
Volume 2, Number 5 July 1982

Route To:

- [x] Manager, Muni. Dept.
- [ ] Underwriting
- [ ] Trading
- [x] Sales
- [ ] Operations
- [x] Compliance
- [ ] Training
- [ ] Other______

Rule G-19

General Review of Requirements Regarding Suitability of Recommendations and Transactions

Questions relating to this notice may be directed to Angela Desmond, Deputy General Counsel.

Over the past year, the Securities and Exchange Commission staff has determined that certain municipal financing instruments such as municipal "commercial paper," and participations in tax-exempt lease purchase or installment sales contracts, are municipal securities and therefore subject to the Board's rules. Also during the past year a variety of municipal securities issues having unusual features, such as variable rate securities, "zero coupon" bonds, "compound interest" bonds and "stepped coupon" bonds have been marketed. Because these products may differ substantially from more traditional municipal securities, the Board believes it appropriate at this time to review generally the requirements of rule G-19, regarding suitability of recommendations and transactions.

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 and prohibits churning of an account.

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.

The rule imposes an affirmative duty of inquiry. If a customer declines to provide the information requested, 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.

With respect to discretionary accounts, absent specific customer authorization of a transaction, the rule 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.

In addition to these suitability obligations, the Board wishes to emphasize that under the antifraud provisions of the federal securities laws, municipal securities professionals may recommend a securities transaction only if there is a reasonable basis for the recommendation.

June 25, 1982

MSRB REPORTS

Volume 2, Number 5 July 1982

Route To:

- [x] Manager, Muni. Dept.
- [ ] Underwriting
- [x] Trading
- [ ] Sales
- [ ] Operations
- [x] Compliance
- [ ] Training
- [ ] Other______

Rule G-30

Recent SEC Decision Concerning Pricing Violations

In a recent opinion the Securities and Exchange Commission sustained the NASD's findings of violations of Board rule G-30 on prices and commissions in connection with certain apparently "riskless principal" transactions.* The opinion is reprinted here because it is the first SEC opinion which discusses the requirements of rule G-30 in depth. The Board intends to publish other significant opinions relating to enforcement of its rules in the future.

* * * * *

SEC Opinion

I.

Staten Securities Corporation, a member firm of the National Association of Securities Dealers, Inc. ("NASD"), and Anthony T. Pallo, Staten's president and principal shareholder, appeal from NASD disciplinary action. The NASD found that applicants charged customers excessive prices in the sale of municipal bonds. It censured applicants, and fined them $2,000, jointly and severally. In addition, it prohibited Pallo, unless supervised by a Municipal Securities Principal, from supervising or effecting principal transactions in municipal securities with public customers until he takes and passes the Municipal Securities Principal Qualification Examination. Our findings are based on an independent review of the record.

II.

Staten is a small securities firm whose transactions in municipal securities accounted for about 40% of its business during the period at issue. The NASD found that from November 1978 to March 1979, Staten and Pallo charged customers unfair prices in eleven principal transactions involving the sale of municipal bonds, thereby violating Rules G-17 and G-30 of the Municipal Securities Rulemaking Board ("MSRB").[1] The bonds in question were issued by the New York State Urban Development Corp., the New York State Dormitory Authority, and the Municipal Assistance Corporation for the City of New York. The NASD found that the markups in question ranged from 5.1% to 6.7% above prevailing market prices, with markups of at least 6% in seven transactions.[2]

Applicants argue that the markups at issue were not excessive under MSRB rules. We cannot agree. We have consistently held markups higher than 10% not only excessive but *fraudulent* in the sale of equity securities.[3] And we have made it clear that markups below that level are not necessarily permissible.[4] In fact, we have found markups in excess of 7% fraudulent in connection with such sales.[5] As a general rule, markups on municipal bonds are significantly lower than those for equity securities.[6] MSRB Rule G-30 contains no specific percentage guidelines to be used in determining whether a particular markup is excessive.[7] The rule requires, however, that prices charged by a municipal securities dealer be "fair and reasonable, taking into consideration all relevant factors. . . ." The prices at issue here clearly do not meet this standard.

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*In the Matter of *Staten Securities Corporation and Anthony T. Pallo,* Securities Exchange Act Release No. 18628 (April 9, 1982), 25 SEC Docket 2006.

[1]Rule G-17 provides that, in the conduct of its municipal securities business, a dealer must deal fairly with all persons. Rule G-30 requires a dealer to sell municipal securities to a customer at an aggregate price that is "fair and reasonable, taking into consideration all relevant factors." Section 15B(c)(1) of the Securities Exchange Act requires brokers, dealers, and municipal securities dealers to comply with the MSRB's rules, and Section 19(g)(1) of the Exchange Act requires the NASD to enforce compliance with those rules.

[2]Applicants argue that the NASD improperly computed the firm's markups, which they claim actually ranged from 4.6% to 6.3%. However, applicants improperly computed the markups as a percentage of the retail prices paid by customers rather than as a percentage of prevailing market prices. In any event, applicants admit that the differences in the markups computed by them and by the NASD are too small to be significant in determining the fairness of the prices at issue.

[3]*See, e.g., J. A. Winston & Co., Inc.,* 42 S.E.C. 62, 69 (1964); *First Pittsburgh Securities Corporation,* Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 406.

[4]*Id.*

[5]*See Century Securities Company,* 43 S.E.C. 371, 379 (1967); *Crow, Brourman & Chatkin, Inc.,* 42 S.E.C. 938, 949 (1966).

[6]*See Edward J. Blumenfeld,* Securities Exchange Act Release No. 16437 (December 19, 1979), 18 SEC Docket 1379, 1382; *DMR Securities, Inc.,* Securities Exchange Act Release No. 16990 (July 21, 1980), 20 SEC Docket 762, 764.

[7]In a Solicitation of Comments on Pricing Guidelines (January 4, 1980), the MSRB asked for public comment with respect to whether it would be appropriate to establish "benchmarks" in connection with MSRB Rule G-30. After receiving comments, the MSRB issued a Report on Pricing (September 26, 1980) in which it decided not to develop specific numeric guidelines. Instead, it indicated that "all relevant factors" should be taken into account in examining municipal securities transactions. The MSRB Report also specifically noted that the NASD's "5% policy," which generally limits markups in connection with corporate securities to five percent, does not apply to municipal securities, and we have not applied that policy here.

As one court has noted, it is the practice in the municipal bond industry to charge retail customers a price which is no more than one-quarter of one percent to five percent over a bond's current market price.[8] Taking into account all relevant factors, we think it clear that the markups in question, which ranged from 5.1% to 6.7%, are excessive.[9] The securities were readily obtainable in the marketplace, with easily ascertainable prices. Each of the sales involved from 5 to 15 bonds and, with one exception, the total price paid by customers ranged from about $10,000 to $17,000.[10] The record does not establish, and applicants do not claim, that the firm was at risk with respect to any of the eleven transactions at issue. Yet the firm realized gross profits in excess of $7,000. In two transactions, the profits exceeded $900; in two others, they were between $700 and $800; in four transactions they were between $600 and $700; in two more, between $500 and $600; and in the remaining transaction, they were about $300.

Applicants claim that various factors, including Pallo's professional qualifications and the time and expense involved in making the trades, fully warrant the markups at issue. Pallo also asserts that he provided customers with various personal financial services, including free investment advice and free advice relating to customers' income tax problems.

We have considered all of the various factors cited by applicants. However, we cannot agree that they warrant the markups that applicants charged. The evidence does not establish that, in effecting the transactions at issue, applicants incurred any unusual expense or, as Pallo claims, expended an "extraordinary amount of time." Nor are we able to conclude that Pallo's "professional qualifications" or the advice he assertedly rendered customers justified the size of the profits that applicants realized.

Applicants also seek to justify their markups on certain sales by pointing to other transactions with the same customer in which they made little or no profit. In most instances, however, applicants did not establish that there was any relationship between the other transactions and the transactions at issue. The fact that applicants may not have made a profit on one transaction cannot justify an excessive markup in an unrelated transaction with the same customer. In the remaining instances, it appears that Staten redeemed securities for a customer and utilized the proceeds to make a new purchase. However, in those instances, we consider that Staten was not entitled to charge more than a modest service fee for its redemption efforts.[11]

We think it clear that applicants charged customers unfair prices in the transactions at issue. Hence we affirm the NASD's findings of violation.[12]

III.

Applicants argue that the sanctions imposed by the NASD are too severe. They assert that neither Pallo, who has been in the securities business for more than 25 years, nor Staten has been the subject of prior disciplinary action by the NASD or this Commission. In addition, applicants assert that, as a result of the NASD's complaint, Pallo has refrained from engaging in the municipal securities business, thereby causing a substantial decrease in applicants' earnings.[13]

As we have seen, applicants engaged in serious misconduct by charging customers excessive prices. Hence we think that the relatively lenient sanctions imposed by the NASD are fully justified. Since those sanctions have been stayed by the NASD, Pallo's determination not to engage in the municipal securities business was purely voluntary on his part. Moreover, we note that the fine imposed on applicants is far less than the profits they derived from their improper activities.[14]

Applicants further argue that the sanctions imposed on them are penal, not remedial. However, we think it clear that the sanctions imposed by the NASD serve "an important remedial function."[15] As the Supreme Court has stated:

> "In determining whether legislation which bases a disqualification on the happening of a certain past event imposes a punishment, the Court has sought to discern the objects on which the enactment in question was focused. Where the source of legislative concern can be thought to be the activity or status from which the individual is barred, the disqualification is not punishment even though it may bear harshly upon one affected."[16]

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[8] *See Securities and Exchange Commission* v. *Charles A. Morris & Associates, Inc.*, 386 F. Supp. 1327, 1334 n.5 (W.D. Tenn. 1973).

[9] This does not mean that markups of 5% or less are necessarily "fair and reasonable." We note that markups on municipal securities are often as low as one or two percent in frequently traded issues, such as those involved in the instant case.

[10] In the remaining transaction, the customer paid about $5,500.

[11] *See Financial Estate Planning*, Securities Exchange Act Release No. 14984 (July 21, 1978), 15 SEC Docket 352, 355.

[12] Applicants' contention that the findings herein must be based on clear and convincing evidence is without merit. *See Steadman* v. *S.E.C.*, 450 U.S. 91 (1981); *Seatton* v. *S.E.C.*,_____ F.2d _____(D.C. Cir., January 8, 1982).

[13] Applicants also argue that the NASD's sanctions run counter to public policy as expressed in the Small Business Act, which calls on the Government to assist and protect small business enterprises such as Staten. However, that policy has no relevance in disciplinary proceedings under the Securities Exchange Act which are instituted to protect public investors.

[14] *See Philip S. Sirianni*, Securities Exchange Act Release No. 17077 (August 20, 1980), 20 SEC Docket 971, 974.

[15] *See, e.g., Robert M. Garrard*, Securities Exchange Act Release No. 12219 (March 17, 1976), 9 SEC Docket 210, 211.

[16] *Flemming* v. *Nestor*, 363 U.S. 603, 613–614 (1960).

Congress adopted the Securities Exchange Act and the Maloney Act amendment thereto as part of a comprehensive scheme to protect the public by maintaining the integrity of the securities markets. In furtherance of that objective, this remedial proceeding was designed to protect the public interest.[17]

Under all the circumstances, we conclude that the sanctions imposed by the NASD are neither excessive nor oppressive.[18]

An appropriate order will issue.[19]

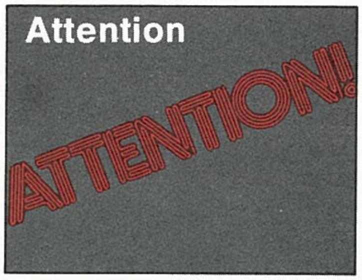
By the Commission (Chairman SHAD and Commissioners LOOMIS, THOMAS and LONGSTRETH); Commissioner EVANS not participating.

George A. Fitzsimmons
Secretary

[17]Applicants further contend that the NASD had no basis for restricting Pallo's activities until he passes the Municipal Securities Principal Qualification Examination. The NASD's Board of Governors concluded that, while Pallo may have felt that he was acting fairly, his erroneous judgment resulted in overcharging customers, and evidenced the need for his requalification by examination. We agree with the NASD that the requalification requirement is an appropriate sanction in light of Pallo's misconduct. And, contrary to applicants' contention, the NASD did not have to charge Pallo with inadequate knowledge of the municipal securities business in order to impose that sanction.

[18]Citing *Steadman* v. *S.E.C.*, 603 F. 2d 1126 (C.A. 5, 1979), *aff'd* 45 U.S. 91 (1981), applicants assert that the NASD did not articulate "compelling" reasons for the sanctions it imposed, nor explain why lesser sanctions would not suffice. Applicants' reliance on *Steadman* is misplaced. The court in that case was prescribing standards for those cases which impose the drastic remedy of a total bar. See 603 F.2d at 1139-1140. Here, as we have seen, the sanctions are far more lenient. Applicants also complain that the NASD did not articulate *any* reason for the sanctions it imposed. However, we consider that the Association's reasons were sufficiently clear. *See Harold C. Allan*, Securities Exchange Act Release No.14763 (May 16, 1978), 14 SEC Docket 1097, 1100.

[19]We have carefully considered all of the arguments advanced by applicants and the NASD. Their contentions are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.



Route To:

- [x] Manager, Muni. Dept.
- [x] Underwriting
- [x] Trading
- [ ] Sales
- [x] Operations
- [x] Compliance
- [ ] Training
- [ ] Other______

Letters of Interpretation

* * * * *

Rule G-33

Day Count Employed in Calculations of Interest on Securities Dated on the 15th of a Month

I am writing in response to your letter of May 26, 1982 in which you inquire as to the correct day count for calculation purposes on a security which is dated on the 15th of a month and pays interest on the first of a following month. In your letter you pose the example of a security dated on June 15, 1982 and paying interest on July 1, 1982, and you inquire whether the July 1, 1982 coupon on such security should have a value of 15 or 16 days of accrued interest.

As you know, Board rule G-33* provides the following formula for use on computations of day counts on securities calculated on a "30/360" day basis:

$$\text{Number of days} = (Y2-Y1)\ 360 + (M2-M1)\ 30 + (D2-D1)$$

In this formula, the variables "Y1", "M1", and "D1" are defined as the year, month, and day, respectively, of the date on which the computation period begins (June 15, 1982, in your example), and "Y2", "M2", and "D2" as the year, month, and day of the date on which the computation period ends (July 1, 1982, in your example). In the situation you present, therefore, the number of days in the period would correctly be computed as follows:

$$\begin{aligned}\text{Number of days} &= (1982-1982)\ 360 + (7-6)\ 30 + (1-15)\\ &\quad \text{or}\\ &= (0)\ 360 + (1)\ 30 + (-14)\\ &\quad \text{or}\\ &= 0 + 30 + (-14)\\ &\quad \text{or}\\ &= 16 \text{ days}\end{aligned}$$

If figured correctly, therefore, the coupon for such a period should have a value of 16 days of accrued interest. If the coupon is for a longer period of time, this particular portion of that longer period would still correctly be counted as 16 days (*e.g.*, the day count on a coupon for the period June 15 to September 1 would correctly be figured as 76 days, consisting of 16 days for the period June 15 to July 1, and 30 days each for the months of July and August).

The error of computing the day count for such a period as 15 days apparently arises from an assumption that, on a security dated on the 15th of a month, accrued interest is owed only for the "second half" of that month. In reality, of course, the 15th of a month is not the first day of the "second half" of that month, but rather is the last day of the "first half" of that month (since a 30-day month consists of two 15-day half-months, the first half being from the 1st to the 15th, and the second half being from the 16th to the 30th). Again, it can clearly be seen that the correct day count for such a period is 16 days.—*MSRB interpretation of June 2, 1982 by Donald F. Donahue, Deputy Executive Director.*

Rule G-8(a)(xi)

Maintenance of Customer Account Information Records

I am writing in response to your letter of May 25, 1982 concerning the maintenance of customer account information records in connection with certain orders placed with you by a correspondent bank. In your letter you indicate that a correspondent bank periodically purchases securities from your dealer department for the accounts of specified customers. The confirmations of these transactions are sent to the correspondent bank, with a statement on each confirmation designating, by customer name, the account for which the transaction was effected. No confirmations or copies of confirmations are sent to the customers identified by the correspondent bank. You inquire whether customer account information records designating these customers as the "beneficial owners" of these accounts need be maintained by your dealer department.

As you know, rule G-8(a)(xi) requires a municipal securities dealer to record certain information about each customer for which it maintains an account. Subparagraph (F) of such paragraph requires that this record identify the

> name and address of beneficial owner or owners of such account if other than the customer *and transactions are to be confirmed to such owner or owners*. . .
>
> (emphasis added)

If the transactions are not to be confirmed to the customers identified as the owners of the accounts for which the transactions are effected, then such information need not be recorded.

In the situation you cite, therefore, the names of the customers need not be recorded on the customer account information record.—*MSRB interpretation of June 1, 1982 by Donald F. Donahue, Deputy Executive Director.*

Rule G-15(a)(viii)

Yield Disclosure on Customer Confirmations of Transactions at Par

I am writing in response to your letter of April 2, 1982, concerning certain of the yield disclosure requirements of Board rule G-15 on customer confirmations. In your letter you note that item (C) of rule G-15(a)(viii) requires that "for transactions at par, the dollar price shall be shown" on the confirmations of such transactions, and you inquire whether it is necessary to show a yield on such confirmations.

Please be advised that a confirmation of a transaction effected at par (*i.e.,* at a dollar price of "100") need show only the dollar price "100" and need not, under the terms of the rule, show the resulting yield.

I note, however, that a transaction effected on the basis of a yield price equal to the interest rate of the security which is the subject of the transaction would be considered, for purposes of the rule, to be a "transaction effected on a yield basis," and therefore would be subject to the requirements of item (A) of rule G-15(a)(viii). The confirmation of such transaction would therefore be required to state "the yield at which [the] transaction was effected and the resulting dollar price [.]"—*MSRB interpretation of April 8, 1982 by Donald F. Donahue, Deputy Executive Director.*

Rule G-23(b)

Whether Certain Mortgage Banking Activities Constitute Financial Advisory Activities

This is in response to your letter of March 26, 1982 requesting an opinion regarding whether Board rule G-23 concerning the activities of financial advisors applies to certain activities of [name deleted] (the "Company").

Your letter states that the Company, a mortgage banker and wholly-owned subsidiary of [name deleted] (the "Bank"), identifies "proposed real estate development projects which it believes are economically feasible" and attempts to "arrange for the financing of such projects. . ." You note that a common means of financing such projects involves the issuance and sale of tax-exempt obligations, with the proceeds of the sale being made available by the issuing entity to a mortgagee approved by the Federal Housing Administration ("FHA"), which in turn provides financing secured by an FHA mortgage. You indicate that the services the Company performs in such instances include ". . .making the initial determination as to whether the contemplated project meets FHA criteria, negotiating with the developer regarding financing terms and conditions relating to the mortgage, contacting the issuer regarding its interest in issuing the bonds for the project, and, in certain cases where the issuer is not familiar or experienced in the area, assisting the issuer in understanding the rules and regulations of the FHA or the Department of Housing and Urban Development. . ." You add that "the Company may also act as servicer of the construction loans which entails processing FHA insurance request forms, disbursing funds for completed work, etc." You state that "the Company does not provide financial advice to issuers regarding the structuring of the bond issues, or receive any fees, directly or indirectly, from issuers." You emphasize that any advice regarding the structuring of the actual bond issues is provided by the issuers' "staffs, financial advisors, bond counsel, or the underwriters of the issues." Your specific question concerns whether rule G-23 applies where the Company acts as mortgage banker and the Bank underwrites the bonds.

As you know, rule G-23(b) states that ". . .a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues for a fee or other compensation. . ." Based upon the representations contained in your letter, it would appear that the Company does not render financial advisory services to issuers with respect to new issues of municipal securities. Since the activities which you state the Company performs in the ordinary course of its mortgage banking business do not constitute financial advisory activities for the purposes of rule G-23, the rule would not apply to those financings where the Bank serves as underwriter and the Company performs its mortgage banking functions, as described.—*MSRB interpretation of April 12, 1982 by Richard B. Nesson, General Counsel.*