MSRB REPORTS

Volume 12, Number 3 | Municipal Securities Rulemaking Board | September 1992

# In This Issue



# Board Elects Fish Chairman; Merritt Vice Chairman

The Board has elected its Chairman and Vice Chairman for its 1993 fiscal year. Charles W. Fish will serve as Chairman and John C. Merritt as Vice Chairman. They will begin their terms on October 1, 1992.

Mr. Fish is Chairman and CEO of Fish & Lederer Investment Counsel, Inc. in Orange, California. Mr. Fish was Vice President for institutional sales with Smith Barney, Harris Upham & Co. for more than three years following 10 years with Crocker National Bank's Investment Division. He received a B.S. from Utah State University.

Mr. Merritt is Chairman and CEO of Van Kampen Merritt Inc. in Philadelphia. He is also Chairman and CEO of Xerox Financial Services Life Company, Chairman of Van Kampen Merritt Life Marketing, Inc. as well as 13 mutual funds for which Van Kampen Merritt is the distributor. Prior to joining Van Kampen Merritt in 1980, Mr. Merritt was a partner at the securities firm Butcher & Singer. He received a B.S. from Babson College.

## Also in This Issue



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**R. Fenn Putman**, *Managing Director*
*Lehman Brothers* . . . . . New York, NY

## Calendar

**September 9** — Effective date of amendments to rule G-3, on professional qualifications

**December 1** — Comments due on suggestions for how customer protection could be improved

**Pending** — Amendment to rule G-12(f), on automated comparison and book-entry settlement of interdealer transactions

— Amendment to rule G-36, on delivery of official statements to the Board

# Staff Appointments

Mark McNair has been appointed Assistant General Counsel. Previously, he served as an attorney at the Securities and Exchange Commission in the Division of Market Regulation. He also worked for 10 years with the Shell Oil Company. Mr. McNair received his B.A. and J.D. degrees at the University of Texas and he holds a Master of Law degree from the Georgetown University Law Center.

Judith A. Somerville has been appointed Uniform Practice Specialist. She previously served as Vice President, Senior Regulatory Compliance Specialist, as well as, Assistant Vice President, Senior Trust Auditor with First Florida Bank, N.A. Ms. Somerville received her B.A. degree from the University of South Florida.

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**Route to:**

- [X] Manager, Muni Dept.
- [ ] Underwriting
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- [ ] Operations
- [ ] Public Finance
- [X] Compliance
- [ ] Training
- [ ] Other

# Customer Protection in the Municipal Securities Market

**Comments Requested**

**As part of the Board's comprehensive review of the adequacy of customer protection measures in the municipal securities market, the Board is requesting comment from all interested parties on potential problem areas in the market and suggestions for how customer protection could be improved.**

The Board is undertaking a comprehensive review of the adequacy of customer protection measures in the municipal securities market. At the conclusion of the review, the Board intends to take appropriate action to address any deficiencies that are discovered. As one part of the Board's review, the Board is requesting comment from all interested parties on potential problem areas in the market and suggestions for how customer protection could be improved. The Board specifically requests comment to identify types of securities or sales practices that are associated with abuses. In this regard, the Board has received reports that problems have arisen with respect to retail transactions in municipal securities with speculative elements, such as unrated and conduit bonds.

This notice discusses the Board's current customer protection rules and provides questions to help commentators address specific issues that are of concern to the Board. The Board intends this to be the first of several notices relating to the Board's customer protection review. Later notices will discuss Board proposals for actions that may be necessary to address any problems that are discovered. These actions may include rule amendments, new enforcement measures, dealer educational efforts, etc. The Board also plans to publish a notice for comment specifically on the future role of the confirmation as a disclosure document.

### Background

In a letter dated May 8, 1992, the Director of the Division of Market Regulation of the Securities and Exchange Commission wrote the Board to request that the Board consider strengthening rule G-19 on suitability of transactions recommended to customers ("SEC letter").[1] The SEC letter suggests, among other things, that additional regulation may be needed to ensure that dealers properly determine the suitability of recommendations made to customers purchasing unrated and conduit bonds.[2]

The Board is aware that, in recent years, there have been a number of defaults of municipal securities issues, including some defaults in unrated and conduit bonds. To the extent that there may be a disproportionate occurrence of defaults in certain types of issues, the Board wishes to ensure that customer protection measures for those issues are adequate. The Board believes that additional customer protection measures will be needed if it is determined that dealers selling certain types of issues are failing to meet required standards for customer protection. These standards include the dealer's obligation to: (i) provide appropriate disclosures; (ii) make the required suitability determinations; and (iii) charge fair and reasonable prices. The Board's concern that these standards be met extends not only to transactions in unrated and conduit securities, but also to transactions in all other municipal securities. The Board accordingly has undertaken a general review to define the nature and scope of any customer protection problems in the market and to determine what measures may be necessary to address them.

### Board's Customer Protection Rules

The Board's three primary customer protection rules are: (i) rule G-17 on fair dealing; (ii) rule G-19 on suitability; and (iii) rule G-30 on fair pricing. These rules are intended to ensure that dealers observe the highest professional standards in their activities and relationships with customers. The professional standards that must be met reflect the dealer's superior position

**Comments on this notice should be submitted no later than December 1, 1992, and may be directed to Harold L. Johnson, Deputy General Counsel. Written comments will be available for public inspection.**

[1] A copy of the letter immediately follows this notice.

[2] Although the Board is not aware of any formal definition of "conduit" securities, it believes that these securities generally are distinguished from general obligation and traditional municipal revenue issues in that the nominal municipal issuer does not undertake a financial commitment on the issue and the revenue stream providing credit for the issue comes from an enterprise, the activities of which are not typically considered governmental functions.

*vis-a-vis* the customer in knowledge of the securities, knowledge of the market, and knowledge of financial matters in general. When these standards are not met and customers suffer losses as a result, the integrity of the entire market is impaired.

### Rule G-17

Rule G-17 states:

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

The Board has interpreted rule G-17 to mean, among other things, that a dealer must disclose to a customer, at or before the time of sale, all material facts concerning the transaction, including a complete description of the security, and must not omit any material facts which would render other statements misleading. The intent of this rule, which is similar to rules operating in all regulated securities markets, is that the customer must be provided with sufficient information to ensure that the customer can make a reasoned and informed investment decision.

Under the standard noted above, the exact nature of the "material facts" required to be disclosed will vary according to the proposed transaction. The crucial test for disclosure is whether the information would be relevant to a reasonable investor seeking to make an informed investment decision. The credit quality of an issue obviously is relevant to all investors and must be disclosed in all cases. In addition, the existence of early redemption provisions always must be disclosed. If credit quality of an issue is questionable or if an early redemption would substantially affect the customer's yield, the importance of these disclosures increases, as does the specificity of the disclosure required.

From time to time, as problems have arisen in the market, the Board has reminded dealers of their duty of full disclosure under rule G-17 and has pointed out some specific items that should always be disclosed to customers. However, it is not possible to construct a comprehensive list of all material facts that might be relevant to all possible transactions. Since a partial list of disclosure items might be construed as a reason for a dealer to omit necessary disclosures, the Board has never attempted to maintain a "checklist" of material facts that must be disclosed under rule G-17.

#### Relationship to Confirmation Requirements

The information required to be recorded on a confirmation by rule G-15(a) does not encompass all of the material facts that must be disclosed under rule G-17. The information required on a customer confirmation serves several purposes including: (i) accurate identification of the securities; (ii) a timely settlement; (iii) a "writing" including the basic terms of the transaction which satisfies state contract law; and (iv) *selected* information about the securities and the transaction which the Board has deemed should be provided in written form to the customer. As discussed above, the Board has not attempted to provide a comprehensive list of all material facts about potential transactions and this is not the purpose of rule G-15(a).

It also should be noted that rule G-17 requires disclosure of material facts at or before the time of trade, with the purpose of allowing the customer to make an informed decision *before* agreeing to the transaction. This requirement for "time of trade" disclosure should not be equated with the sending of a confirmation, as required under rule G-15(a). Because the confirmation is provided to the customer after the customer agrees to the transaction, confirmation disclosure does not satisfy the dealer's disclosure duty under rule G-17. Notwithstanding this fact, confirmation disclosure historically has supported customer protection measures in the municipal securities market because rule G-15(a) requires a number of substantive disclosures which a customer can review on the confirmation prior to paying for the securities.

The future role of the confirmation as a disclosure document may be shaped by several factors, including the pressure to provide increasing amounts of disclosure on a relatively small document. The degree of customer protection provided by the confirmation also may be affected by the proposal currently being considered in the securities industry to shorten the regular-way settlement cycle to three business days.[3] Shortening the settlement cycle, in many cases, would delay a customer's receipt of the confirmation until after the customer's payment for the securities has been made, which would appear to reduce the value of the confirmation as a customer protection measure. In the near future the Board plans to publish a notice requesting comment on the future role of the confirmation as a disclosure document.

#### Relationship to Rule G-32

Rule G-32 requires delivery of final official statements (and in the case of negotiated issues, certain additional written information) to customers purchasing new issue municipal securities. The rule states that the customer must receive the official statement (if one has been prepared by the issuer) no later than settlement of the transaction. The requirement to deliver a final official statement to the customer prior to settlement does not release the dealer from its obligation to provide "time of trade" disclosure under rule G-17. Of course, an official statement (or a preliminary official statement) may be used to provide certain disclosures to a customer prior to the trade, if the document is provided to the customer before the customer agrees to the trade.

### Rule G-19

In general, rule G-19 requires a dealer to know its customer and any security that is recommended to the customer. The dealer, with this knowledge, must then ensure that transactions recommended to the customer are suitable for the customer. With respect to knowing the customer, rule G-19 states that a dealer shall either have knowledge or inquire about "the customer's financial background, tax status, and investment objectives and any other similar information." Inquiries about the customer's financial situation generally are made at or before the opening of each customer account and rule G-8(a)(xi) requires the information supplied to be maintained in

[3] *See MSRB Reports* Vol. 10, No. 4 (October 1990) at 11-18.

the customer account record to assist in monitoring compliance with the rule. Dealers must ensure that these records on the customer's financial situation are kept current if subsequent recommendations are made to the customer.[4]

Rule G-19 further states two requirements that are applicable to *each recommendation* made to the customer. The first is a requirement to know the security. The rule states that the dealer shall not recommend any specific transaction in a security unless the dealer has reasonable grounds, based on the information available from the issuer of the security or otherwise, for recommending a purchase, sale or other transaction in the security.

The second requirement that must be met for each recommendation concerns the suitability of the transaction for the particular customer. This requirement can be met in either of two ways:

- The dealer has reasonable grounds to believe and does believe that the recommendation is suitable for such customer in light of the customer's financial background, tax status, and investment objectives and any other similar information concerning the customer known by the dealer; or
- The dealer has no reasonable grounds to believe and does not believe that the recommendation is unsuitable for such customer, if all of such information is not furnished or known.[5] This provision does not relieve a dealer from the duty to make suitability inquiries prior to recommending transactions.

The rule states that, notwithstanding the above requirements, if a dealer determines that a transaction is not suitable for the customer *and so informs the customer*, the dealer may "respond to the customer's requests for investment advice concerning municipal securities generally or such specific securities and may execute transactions at the direction of the customer."

### Rule G-30

Rule G-30 requires dealers to effect transactions with customers at fair and reasonable prices. The Board does not provide specific numeric mark-up guidelines to dealers because of the heterogeneous nature of the market and the many different types of customer transactions. The rule states that the fairness and reasonableness of the aggregate price of a transaction is determined in light of all relevant factors, including the best judgment of the dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the dealer is entitled to a profit, and the total dollar amount of the transaction.

In its September 1980 Report on Pricing, the Board provided additional guidance to dealers and enforcement agencies on how to determine the fairness and reasonableness of prices. In that report, the Board noted that the yield to a customer is the most important factor in judging fairness and reasonableness of price. The report states that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate and block size then available in the market.

### Request for Comment

The following questions are provided to guide commentators in addressing issues that are of concern to the Board.

#### General Questions

- In general, how well are the Board's current customer protection rules working?
- What kinds of customer protection problems exist in the industry and how widespread are they?
- Are the problems limited to specific types of securities (*e.g.*, unrated securities, high yield securities, conduit securities, special types of conduit securities)?
- Do the problems relate primarily to disclosure, suitability, pricing or other areas?

#### Disclosure to Customers

- What items of information typically are disclosed to customers at the time of trade, (*e.g.*, details of all call features, credit structure, ratings, etc.)?
- Does the content or extent of disclosure depend upon the type of security (*e.g.*, general obligation, traditional revenue, conduit, rated, unrated)?
- Does the content or extent of disclosure given to the customer depend upon the type of customer (*e.g.*, institutional versus retail, sophisticated versus unsophisticated, new account versus established customer)?
- Do dealers prepare written descriptive material to be used by sales personnel in describing securities for sale? What information typically is included on these documents?
- To what extent are credit ratings relied upon to disclose credit risk to customers?
- How is disclosure of credit risk handled for unrated and conduit securities? — in the primary market? — in the secondary market?
- Are sales personnel required to review official statements for new issues prior to selling them? How extensive is the use of preliminary official statements in making disclosures to customers?
- Are final official statements generally received by new issue customers prior to settlement, as required by rule G-32?
- Do dealers always receive official statements in time to deliver them to customers prior to settlement, as required by rule G-32?
- What sources of information are available for secondary market issues? What resources typically are utilized (*e.g.*, description services, rating agency reports, official state ments)? Are these sources adequate to effect disclosure of all material facts?
- How are disclosures being made to customers at or prior to time of trade (*e.g.*, in writing, orally by telephone, etc.)?
- Does the method of the disclosure vary according to whether the customer is institutional or retail? — sophisticated or

[4] If a customer refuses to supply financial information upon request, this can be noted in the customer account record. *See MSRB Reports* Vol. 7, No. 1 (January 1987), at 23-24 and *MSRB Reports* Vol. 8, No.2 (March 1988) at 10-11.

[5] The SEC letter suggests that the Board consider eliminating this provision and thus require that specified information bearing on the suitability of a transaction be obtained from the customer in all instances. If such information were not supplied, the recommendations could not be made.

unsophisticated?
- Are written disclosures (in addition to the confirmation) provided to secondary market customers?
- To the extent that disclosures are made orally by sales personnel, how are these disclosures monitored by supervisory personnel to ensure compliance with rule G-17?

**Suitability**

- Are dealers routinely obtaining information for each customer account reflecting the net worth, income level, and investment objectives of the customer? Is this information obtained at the opening of the customer account? — prior to the first transaction?
- Is the nature and extent of this customer financial information obtained dependent upon the type of customer (*e.g.*, retail versus institutional)?
- Is all customer financial information obtained routinely recorded in the dealers records, as required by rule G-8(a)?
- How often do customers refuse to provide relevant financial information? Is this fact noted in the customer account records?
- If a customer does not provide all requested financial information, are transactions nevertheless recommended? Does this depend upon whether the customer is an individual or institutional customer?
- Do dealers update the customer's financial information each time a recommendation is made?
- Are special measures taken when making or recording suitability determinations for individual customers purchasing unrated or conduit securities? Are minimum liquid net worth levels required for recommendations of certain types of risky municipal securities?
- Are there certain types of municipal securities that generally are not suitable for retail accounts below a certain net worth?
- How are suitability determinations supervised?

**September 4, 1992**

## Letter from the SEC to the Board

May 8, 1992

Christopher A. Taylor
Municipal Securities Rulemaking Board
Suite 800
1818 N Street, N.W.
Washington, D.C. 20036-0347

Re: *Suitability Concerns in Municipal Securities Transactions*

Dear Kit:

I am writing to suggest that the Municipal Securities Rulemaking Board ("MSRB" or "Board") consider strengthening the Board's customer suitability requirements in connection with transactions in certain types of municipal securities.

The Commission and the Board have acted jointly in a continuing effort to improve disclosure practices in the municipal securities market and to strengthen investor protection.[1] Less attention has been given to the obligations of brokers-dealers and their salespersons to determine the suitability of more speculative municipal bonds for investors who may lack the financial sophistication to fully appreciate the risks involved or the means to sustain a complete or substantial loss of their investments. Suitability issues are raised in particular by the well-publicized defaults of certain unrated and conduit bonds, some of which may have been marketed to unsophisticated investors.

By operation of Section 15A(f) of the Securities Exchange Act of 1934 ("Exchange Act"),[2] transactions in municipal securities are not covered by the sales practice rules of the National Association of Securities Dealers, Inc. ("NASD"). One NASD rule requires that NASD members recommending securities transactions to their customers must in each case have reasonable grounds to believe that the recommendation is suitable for the customer based on information provided by the customer concerning the customer's other securities holdings, financial situation, and needs.[3]

MSRB rule G-19[4] requires that, in recommending transactions in municipal securities, broker-dealers, prior to the recommendation, must "inquire" as to the customer's financial background, tax status, investment objectives, and similar information. The rule requires that the broker-dealer must either (1) have reasonable grounds to believe that the recommendation is suitable in light of such information that it knows or (2) have no reasonable grounds to believe that the recommendation is unsuitable for the customer if all of such information is not furnished or known. MSRB rule G-8[5] requires that any such information that is obtained be retained in the firm's records. These provisions do not specify the manner in which the

[1] The Commission recently approved the Board's proposal to establish and operate a Continuing Disclosure Information Pilot System, which is designed to accept and disseminate voluntary submissions of continuing information relating to outstanding issues of municipal securities. Securities Exchange Act Release No. 30556 (April 6, 1992), 56 FR 12534. This project will function as part of the Board's Municipal Securities Information Library, which was previously approved by the Commission. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194.

[2] 15 U.S.C. 78o-3(f).

[3] NASD Rules of Fair Practice, Art. III, Section 2, NASD Manual (CCH) ¶ 2152. Commission and court decisions have held that a broker-dealer must determine the suitability of its recommendations based on what has been disclosed by the customer, and in the absence of disclosure, the broker-dealer cannot safely assume that a recommendation is suitable for a customer. *See, e.g., Erdos v. SEC*, 742 F.2d 507 (9th Cir. 1984); *Gerald M. Greenberg*, 40 S.E.C. 133 (1960).

[4] MSRB Manual (CCH) ¶ 3591.

[5] MSRB Manual (CCH) ¶ 3536.

suitability determination should be made, and they do not require that the determination be made in writing.

In light of the effect on individual investors on defaults involving unrated or conduit bonds, I believe it would be appropriate for the Board to review its suitability requirements with a view to strengthening these requirements. Because of its ready access to information concerning the market, the Board may be able to obtain information to determine the extent to which firms currently fail to make suitability determinations, whether such determinations are made but are based on insufficient information or are not properly documented, or whether investors are appropriately informed of potential risks involving speculative bonds but still choose to purchase them.

In the course of its review of suitability practices, the Board may wish to consider whether broker-dealers should in each case be required to obtain specified information bearing on suitability prior to the recommendation or the transaction. In particular, it may be useful to review the effect of the provision of rule G-19 that permits the transaction to go forward if the firm lacks relevant information but has "no reasonable grounds to believe the recommendation is unsuitable." The Board also could examine whether the basis for a suitability determination with respect to certain types of particularly risky municipal securities should be required to be recorded in writing, and whether the customer should be required to execute and return the written determination before the transaction.[6] These examples are meant to be illustrative and are not meant to prejudge the Board's determination of whether changes should be made and, if so, what form they should take.

I look forward to hearing from you and the Board concerning the issues raised in this letter.

Sincerely,

William H. Heyman
Director

cc: Chairman Breeden
Commissioner Beese
Commissioner Roberts
Commissioner Schapiro

[6] *Cf.* Rule 15c2-6(b)(4) under the Exchange Act, requiring broker-dealers to obtain a manually signed and dated copy of the suitability statement required by the rule prior to approving an account for transactions in designated securities.

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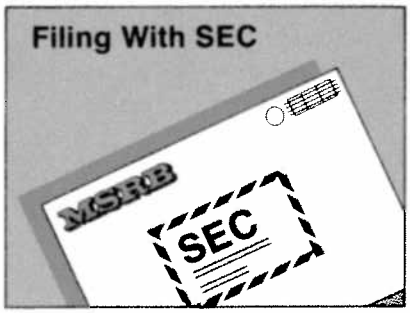


**Route to:**

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# Board Finalizes Implementation Plan for Automated Clearance and Settlement Revisions: Rules G-12 and G-15

## Plan Finalized and Amendment Filed

**The Board has finalized its plan for expanding the use of automated clearance and settlement systems in the municipal securities market. In addition, the Board has filed an amendment to rule G-12(f)(ii) to require all inter-dealer transactions in depository-eligible securities to be settled with book-entry delivery.**

The Board has finalized its plan for expanding the use of automated clearance and settlement systems in the municipal securities market. The Board published the plan for comment in April 1992.[1] At its July 1992 meeting, the Board approved the plan and authorized the filing of the first phase of the plan with the Securities and Exchange Commission for approval.

### Implementation Plan

The Board's plan for expanding the use of automated clearance and settlement systems includes two amendments to rule G-12(f), on automated comparison and book-entry settlement of inter-dealer transactions, and two amendments to rule G-15(d), on automated confirmation/affirmation and book-entry settlement of Delivery Versus Payment and Receipt Versus Payment ("DVP/RVP") customer transactions.[2] None of the amendments contemplated by the Board would affect retail customer transactions. Under the plan, the following requirements would become effective on the dates indicated:[3]

January 1, 1993 — *Amendment to rule G-12(f)(ii)*: All inter-dealer transactions in depository-eligible securities must be settled by book-entry delivery.

July 1, 1993 — *Amendment to rule G-15(d)(iii)*: All DVP/RVP customer transactions in depository-eligible securities must be settled by book-entry delivery (with an exception made for purchases made by issuers or trustees to retire securities); *and*

*Amendment to rule G-12(f)(i)*: All inter-dealer transactions eligible for automated comparison must be compared in an automated system.

July 1, 1994 — *Amendment to rule G-15(d)(ii)*: All DVP/RVP customer transactions eligible for automated confirmation/affirmation must be confirmed/affirmed in an automated sytem.

### Comments on Implementation Plan

After its April 1992 request for comment, the Board received two comments on the plan, which were generally supportive. One commentator on the implementation plan suggested that the amendment requiring use of the automated comparison system for inter-dealer transactions should be implemented concurrently with the amendment relating to book-entry settlement of inter-dealer transactions. While the Board agrees with the commentator that full use of the automated comparison system should be an industry priority, it has decided to maintain its original schedule, which provides an additional six months before implementation of the amendment on automated comparison. The Board believes that some dealers who do not now use the automated comparison system may need this additional time to prepare for its use.[4]

### Need for Preparation

Although the final phase of the plan will not be implemented until 1994, dealers should review the plan at this time and begin preparations. Dealers should consider any changes that may

**Questions about the implementation plan or amendments may be directed to Harold L. Johnson, Deputy General Counsel.**

[1] *MSRB Reports* Vol. 12, No. 1 (April 1992), at 31-36.
[2] DVP/RVP customer transactions essentially are the same as institutional customer transactions.
[3] For a complete discussion of each amendment, *see MSRB Reports* Vol. 12, No.1 (April 1992) at 31-36.
[4] In contrast, the Board believes that essentially all dealers now have access to and use book-entry settlement systems for most of their inter-dealer transactions.

be necessary not only in their own clearance and settlement practices, but also in the clearance and settlement practices of their institutional customers. The Board urges dealers to begin working as soon as possible with institutional customers who do not now use book-entry settlement and/or automated confirmation/affirmation, as these services will become mandatory for DVP/RVP customer transactions in July 1993 and July 1994, respectively.

**Summary of Amendment to Rule G-12(f)(ii)**

As noted above, the first phase of the Board's plan is an amendment to rule G-12(f)(ii) to require all inter-dealer transactions in depository-eligible securities to be settled with book-entry delivery. On August 27, 1992, the Board filed this amendment with the SEC for approval.[5]

Currently, rule G-12(f)(i) requires an inter-dealer transaction to be settled by book-entry delivery under the following conditions:

(1) the transaction has been compared in the automated comparison system;

(2) each party to the transaction is a member of a securities depository registered with the SEC ("depository") or its clearing agent for the transaction is a member; and,

3) the securities are eligible for deposit at a depository of which both parties are members, or, if the parties are members of different depositories, the securities are eligible at each of the two depositories.

Under the amendment filed by the Board, a dealer would be required to make book-entry settlement of all of its inter-dealer transactions in municipal securities, except for certain transactions involving securities that are not depository-eligible.[6] The primary effect of this change would be to eliminate the current exemption in the rule for transactions involving dealers that are not direct members of a securities depository.

The amendment does not require dealers to apply to make municipal securities depository eligible.[7] However, it should be noted that there are programs now underway at depositories to make bearer municipal securities automatically eligible, based on the trade data submitted to automated comparison and automated confirmation/affirmation systems. To the extent that these programs result in a security being made depository-eligible between trade date and settlement date, the amendment would require book-entry settlement of those transactions.

The text of the amendment to rule G-12(f)(ii) follows. The Board will provide notice of filing of the remaining amendments to rules G-12(f) and G-15(d) in subsequent issues of *MSRB Reports*.

**August 27, 1992**

## Text of Amendments*

**Rule G-12. Uniform Practice**

(a) through (e) No change.

(f) *Use of Automated Comparison, Clearance, and Settlement Systems.*

(i) No change.

(ii) Notwithstanding the provisions of section (e) of this rule, ~~if a transaction submitted to one or more registered clearing agencies for comparison in accordance with paragraph (i) above has been compared successfully, and if such transaction involves municipal securities which are eligible for deposit at one or more securities depositories registered with the Securities and Exchange Commission in which both parties to the transaction are members, the parties to such transaction shall settle the transaction by book-entry through the facilities of the depository or through the interface or link, if any, between the depositories~~. a transaction eligible for book-entry settlement at a securities depository registered with the Securities and Exchange Commission (depository) shall be settled by book-entry through the facilities of a depository or through the interface between two depositories. Each party to such a transaction shall submit or cause to be submitted to a depository all information and instructions required from the party by the depository for book-entry settlement of the transaction to occur; *provided that*, if a party to a transaction has made arrangements, through its clearing agent or otherwise, to use one or more depositories exclusively, a transaction by that party shall not be subject to the requirements of this paragraph (ii) if the transaction is ineligible for book-entry settlement at all such depositories with which such arrangements have been made.

(iii) For purposes of paragraph (ii) of this section (f) a municipal securities broker or municipal securities dealer who clears a transaction through an agent who is a member of a registered clearing agency ~~or a registered securities depository~~ shall be deemed to be a member of such registered clearing agency ~~or registered securities depository~~ with respect to such transaction.

(g) through (l) No change.

[5] SEC File No. SR-MSRB-92-6. Persons wishing to comment to the SEC on the filing should refer to this file number.

[6] If the parties to a transaction are members of different depositories, then they must arrange to use the interface between the depositories to accomplish a book-entry delivery. However, if the securities involved in a transaction are ineligible at the exclusive depository (or depositories) being used by one of the parties to the transaction, a book-entry delivery may not be possible. Thus, the amendment does not require book-entry settlement in this case. The Board believes that the number of issues that fit within this exception is relatively small, but that the exception is necessary to ensure that the amendment is not construed as requiring all dealers to have access to all depositories in order to comply with the proposed rule change.

[7] Thus, the amendment does not require an underwriter to accomplish the initial inter-dealer distribution of the issue through a depository unless the underwriter chooses to do so by making the issue eligible at a depository prior to the distribution. Once an issue is made eligible at a depository, however, all subsequent transactions would be subject to the requirement of book-entry delivery according to the provisions discussed above.

* Underlining indicates new language; strikethrough denotes deletions.

MSRB REPORTS
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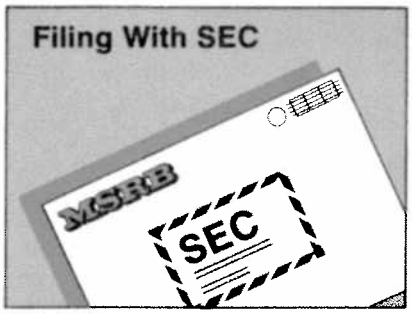



**Route to:**

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

# Delivery of Official Statements to the Board: Rule G-36

### Amendment Filed

**The amendment requires underwriters to send to the Board copies of official statements (along with completed Forms G-36(OS)) for all primary offerings, with the exception of limited placements, if such documents are prepared by or on behalf of the issuer.**

On September 3, 1992, the Board filed with the Securities and Exchange Commission a proposed amendment to rule G-36, on delivery of official statements to the Board. The amendment requires underwriters to send to the Board copies of official statements (along with completed Forms G-36(OS)) for all primary offerings, with the exception of limited placements, if such documents are prepared by or on behalf of the issuer. The amendment will become effective upon approval by the Commission. Persons wishing to comment on the amendment should comment directly to the Commission.[1]

### Background

Rule G-36 currently requires that brokers, dealers and municipal securities dealers deliver to the Board, among other things, copies of final official statements for most primary offerings, if such documents are prepared by or on behalf of the issuer.[2] These official statements then are made available to interested parties through the Board's Municipal Securities Information Library™ (MSIL™) system.[3] The rule provides an exemption from this delivery requirement for primary offerings with authorized denominations of $100,000 or more if such securities (1) have maturities of nine months or less; (2) have put options (at par or greater) at least as frequently as every nine months until redemption or repurchase; or (3) are "limited placements" as that term is used in SEC Rule 15c2-12, regarding preparation of official statements.

An underwriter's specific obligations under rule G-36 are governed, in part, by whether the offering is subject to SEC Rule 15c2-12, relating to preparation of official statements. In general, SEC Rule 15c2-12 requires underwriters participating in primary offerings of municipal securities of $1 million or more to obtain, review, and distribute to investors copies of final official statements. The rule also requires underwriters to, among other things, contract with the issuer to receive a sufficient number of copies of the final official statement to comply with Board rules.

Certain primary offerings of municipal securities are not subject to the requirements of SEC Rule 15c2-12. The rule does not apply to (i) offerings under $1 million in par value; and (ii) offerings that are specifically exempted under section (c) of that rule. The three categories of offerings that fall under this exemption are those primary offerings with authorized denominations of $100,000 or more and which:

(1) are sold to no more than thirty-five persons, each of whom the underwriter reasonably believes (i) has such knowledge and experience in financial and business matter that it is capable of evaluating the merits and risks of the prospective investment and (ii) is not purchasing for more than one account or with a view to distributing the securities (referred to herein as "limited placements"); or

(2) have maturities of nine months or less; or

(3) at the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or repurchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

While SEC Rule 15c2-12 applies to primary offerings with aggregate principal amounts of $1 million or more (unless

**Questions about the amendment may be directed to Jill C. Finder, Assistant General Counsel.**

[1] Comments sent to the Commission should refer to SEC File No. SR-MSRB-92-7.

[2] For purposes of rule G-36, the following terms have the following meanings:
(i) A "final official statement" is defined as a document or set of documents prepared by an issuer of municipal securities or its representative, setting forth, among other things, information concerning the issuer(s) of such securities and the proposed issue that is complete as of the date of delivery of the document or set of documents to the underwriter.
(ii) A "primary offering" is an offering of municipal securities directly or indirectly by or on behalf of an issuer of such securities, including certain remarketings.

[3] Municipal Securities Information Library and MSIL are trademarks of the Board.

specifically exempted from that rule), rule G-36 applies to primary offerings of $1 million or more, as well as to offerings under $1 million. For offerings of $1 million or more, rule G-36 requires that the underwriter send to the Board two copies of the official statement along with two completed Forms G-36(OS)[4] within one business day of receiving the official statement from the issuer, but in no event later than 10 business days after the date of the final agreement to purchase, offer or sell the securities. For issues under $1 million, rule G-36 requires that if the issuer has voluntarily prepared an official statement, then the underwriter must send the documents to the Board within one business day of settlement or closing of the issue. However, the requirements of rule G-36 currently do not apply to offerings that qualify for an exemption under SEC Rule 15c2-12(c), regardless of the amount of the offering. While there is no mandatory delivery requirement for such exempt offerings, copies of official statements for such offerings are included in the MSIL system if an issuer voluntarily prepares an official statement and the underwriter voluntarily provides copies of that document (along with completed Forms G-36(OS)) to the Board. The Board specifically exempted these offerings from the scope of rule G-36 when it adopted the rule in 1989. At that time, the Board noted that SEC Rule 15c2-12 does not require that official statements be prepared for such offerings, and the Board believed that official statements voluntarily prepared for such offerings probably would be of little interest to the market.

At a meeting of the Board's MSIL Advisory Committee,[5] several committee members stated that the Board should ensure that its collection of official statements in the MSIL system is as complete as possible. Several committee members noted that disclosure documents for short-term securities, such as those nine months or under in maturity, were an important source of information about municipal issuers. Based on these comments, as well as the experience gained by the Board over the last several years in collecting and disseminating official statements, the Board believes that there is interest among market participants in obtaining official statements relating to offerings that are currently exempt from Board rule G-36, *i.e.*, offerings with maturities of nine months or less (which includes short-term notes), and offerings with put periods of nine months or less (which includes variable rate demand obligations).

### Summary of Comments and Discussion

In April 1992, the Board solicited comments on proposed amendments to rule G-36 in an exposure draft,[6] and received four comment letters in response thereto.[7] One commentator provided information on limited placements; one commentator opposed the inclusion of short-term and limited placement offerings; one commentator supported the amendments in their entirety; and one commentator opposed any expansion of the rule. The commentators provided the following specific comments:

#### Limited Placements

None of the commentators suggested that limited placements be included within the scope of rule G-36. Two commentators believe that private placement memoranda differ from official statements, and that such documents are not intended for public distribution. One of these commentators believes that this mode of marketing sometimes is chosen to ensure the confidentiality of financial information, and that a mandatory delivery requirement would have a chilling effect on private placements. Nevertheless, this commentator believes that voluntary filings would provide useful information to the market without misleading the public because underwriters can refrain from filing in instances in which the disclosure would be misleading. One commentator believes that although some of these securities enter the public market, making the memoranda publicly available could lead to misuse of the information. The Board concurs with the commentators.

#### Variable Rate Demand Obligations ("VRDOs") and Short-Term Offerings

Two commentators believe that there is limited secondary market activity in VRDOs and short-term securities, and, consequently, that there would be little, if any, benefit to including disclosure documents for such securities in the MSIL system. In contrast, members of the MSIL Advisory Committee have commented that such issues sometimes appear in the secondary market, and that it would be desirable for the Board to collect and make available these documents. The Board notes that primary offerings of short-term notes and VRDOs often are fairly large in par value and, in some cases, are actively traded in the market. Thus, the Board believes that, on balance, including such documents in the MSIL system would benefit the market by increasing public access to these disclosure documents.[8]

Some of the commentators believe that information disseminated from the MSIL system may be misleading to investors if, for example, circumstances have changed and the documents are no longer current or reliable, or if the investor attempts to apply information in the document to other securities to which the document does not relate, and for which purpose the document was not intended. The Board notes that such an argument can be applied to any of the official statements currently provided to the Board under rule G-36. The Board believes that these documents clearly describe the issues to which they relate and their dates of preparation. One commentator suggests that the Board place a legend on any materials disseminated from the MSIL system indicating that such materials are dated and may no longer be reliable. The Board has done so.

[4] Form G-36(OS) requires the party sending the official statement to provide certain information which is necessary for the Board to process such documents for inclusion in the MSIL system.

[5] The MSIL Advisory Committee advises the Board on MSIL system operations. It is comprised of 26 individuals, representing a cross-section of municipal securities participants. The Committee met on January 15, 1992, in New York City, at which time the scope of rule G-36 was discussed.

[6] *MSRB Reports*, Vol. 12, No. 1 at 17-19 (April 1992).

[7] The comment letters are available for inspection at the Board's offices.

[8] As noted above, some underwriters now send official statements for these offerings to the Board on a voluntary basis. The Board currently enters these documents into the MSIL system and makes them available to the public for inspection and copying.

One of the commentators believes that including VRDOs and short-term offerings within the scope of rule G-36 would increase costs for issuers. This commentator states that the VRDO market is specialized and that if issuers believe that their documents may be accessed through the MSIL system and relied upon by unsophisticated investors, then they may be forced to make more comprehensive disclosure to avoid liability. Similarly, the commentator argues that disclosure that may be adequate for short-term securities may be misleading when applied to that issuer's long-term obligations, and that in order to avoid liability, such issuers may be forced to produce more comprehensive (and expensive) disclosure documents in connection with short-term securities.

The Board is prohibited from regulating the form and content of issuers' disclosure documents, and from requiring issuers to prepare official statements. Thus, the Board cannot require issuers to produce (or deliver) more comprehensive disclosure documents. The Board's efforts in this area have been aimed solely at enhancing the availability of, and accessibility to, existing disclosure documents. The Board believes that expanding the scope of rule G-36 will enhance public access to these important disclosure documents, in furtherance of the Board's statutory purposes.

In creating the MSIL system, the Board repeatedly has expressed its concern that the general lack of access to information about municipal securities and their issuers is detrimental to the overall integrity and efficiency of the municipal securities market. The Board determined to adopt the amendments because it believes that expanding the scope of rule G-36 to include offerings with maturities of nine months or less and offerings with put periods of nine months or less will result in a more complete collection of disclosure documents, thereby increasing the overall integrity, efficiency and liquidity of the municipal securities market.

**September 3, 1992**

## Text of Amendments*

**Rule G-36 Delivery of Official Statements, Advanced Refunding Documents and Forms G-36(OS) and G-36(ARD) to Board or Its Designee**

(a) through (b) No change.

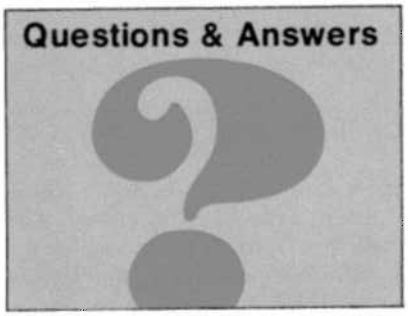
(c) *Delivery Requirements for Issues not Subject to Securities Exchange Act Rule 15c2-12.*

(i) No change.

(ii) This section shall not apply to primary offerings of municipal securities, regardless of the amount of the issue, if the issue qualifies for an exemption set forth in paragraph (1) of section (c) of Securities Exchange Act rule 15c2-12~~(e)~~.

(d) through (g) No change.

* Underlining indicates additions; strikethrough denotes deletions.




**Route to:**

- [X] Manager, Muni Dept.
- [X] Underwriting
- [ ] Trading
- [ ] Sales
- [ ] Operations
- [X] Public Finance
- [X] Compliance
- [ ] Training
- [ ] Other

# Forms G-36(OS) and G-36(ARD)

**Questions and Answers**

**Rule G-36 requires an underwriter (or if there is an underwriting syndicate, the managing underwriter) to submit to the Board two copies of final official statements and advance refunding documents for most new issues of municipal securities. These documents must be accompanied by two completed copies of Form G-36(OS) (for official statements) or Form G-36(ARD) (for advance refunding documents). The underwriter also must submit to the Board copies of amended or "stickered" official statements if the amendment occurs after the Board has received the original, final official statements.**

**The Board returns Forms G-36(OS) and G-36(ARD) to the sender if they are incomplete or incorrectly completed. If a line on the form is not applicable to a particular official statement or advance refunding document, underwriters should complete the line by indicating "not applicable" and not leave the line incomplete. The Board has prepared a booklet, *Instructions for Filing Forms G-36*, that explains the information, line by line, that should be included on the Forms G-36. This booklet may be ordered free of charge by using the Publications Order Form on page 21 of this issue of *MSRB Reports*. The Board has prepared this notice to address the most frequently asked questions concerning the preparation of Forms G-36(OS) and G-36(ARD).**

## FREQUENTLY ASKED QUESTIONS ABOUT FORM G-36(OS)

**Q: What is the difference between line 7 (par value of the offering) and line 8 (par amount underwritten (if there is no underwriting syndicate))?**

A: Line 7 asks for the par value of all the securities described in the official statement regardless of different series, issues or types of bonds or notes. Line 8 asks for information concerning the amount of the issue or issues purchased by the underwriter if there is no underwriting syndicate,[1] and if the underwriter purchased only a portion of the offering, as often occurs on note deals. Line 7 and line 8 may be the same amount, however line 8 is used for billing underwriting assessment fees pursuant to rule A-13. Thus, if the underwriter is not responsible for all the assessment fee due on the offering, they must fill in the portion of the offering that they are responsible for on line 8.

**Q: What is the purpose of line 9 (Is this an amended or stickered official statement?)?**

A: Line 9 is a verification that the official statement received is in final form with all attachments as needed. If line 9 is checked yes and no amendment or supplement is in the package, the MSIL staff are then alerted that a problem may exist or that the official statement may be an updated version of a document previously received by the Board.

**Q: Why must line 13 (signature line) be signed if there is a name on line 12 (name and phone)?**

A: Rule G-36 requires underwriters to send only final official statements concerning primary offerings of municipal securities.[2] Line 12 asks for information concerning the employee of the underwriter who is responsible for rule G-36 compliance. Line 13 is to confirm that the document being sent is a final official statement for a primary offering of municipal securities. Line 12 and line 13 need not be the same person if the underwriter designates another firm to send the official statements to the Board (see lines 14 and 15). Even if line 12 and line 13 are the same person, the Board requires line 13 to be signed to ensure that responsible parties review the submission and confirm that the documents sent are as required by rule G-36.

## FREQUENTLY ASKED QUESTIONS ABOUT FORM G-36(ARD)

**Q: What is the difference between line 16 (original infor-**

[1] See the Board's *Glossary of Municipal Securities Terms* for clarification of this term.
[2] Primary offering and final official statement are defined by SEC Rule 15c2-12.

| | | |
|---|---|---|
| | | (NASD) and "Arbitrator Disclosures and Other Ethical Considerations" by Judith Hale Norris, Esq. (NASD)) |
| October 21, 1992 | Denver | (Topic: Same as Dallas above) |

In some instances, the NASD arbitrator orientations sessions and forums are combined. Fees are not charged to attendees of these programs.

The NASD also hosts arbitrator luncheons and full-day training seminars for which there is a fee. For further information, contact the National Association of Securities Dealers, Inc., Arbitration Department, 33 Whitehall Street, 8th Floor, New York, NY 10004, (212) 858-4400.

# Publications List

## Manuals and Rule Texts

**MSRB Manual**
Soft-cover edition containing the text of MSRB rules, interpretive notices and letters, samples of forms, texts of the Securities Exchange Act of 1934 and of the Securities Investor Protection Act of 1970, as amended, and other applicable rules and regulations affecting the industry. Reprinted semi-annually.
April 1, 1992 ..... $5.00

**Glossary of Municipal Securities Terms**
Glossary of terms (adapted from the State of Florida's *Glossary of Municipal Bond Terms*) defined according to use in the municipal securities industry.
1985 ..... $1.50

**Instructions for Filing Forms G-36**
This publication is available to assist underwriters in submitting official statements, advance refunding documents and complete and correct Forms G-36.
1992 ..... no charge

**Professional Qualification Handbook**
A guide to the requirements for qualification as a municipal securities representative, principal, sales principal and financial and operations principal, with questions and answers on each category. Includes sections on examination procedures, waivers, disqualification and lapse of qualification, the text of MSRB qualification rules and a glossary of terms.
1990 ..... 5 copies per order ..... no charge
Each additional copy ..... $1.50

**Manual on Close-Out Procedures**
A discussion of the close-out procedures of rule G-12(h)(i) in a question and answer format. Includes the text of rule G-12(h)(i) with each sentence indexed to particular questions, and a glossary of terms.
January 1, 1985 ..... $3.00

**Arbitration Information and Rules**
Based on SICA's *Arbitration Procedures* and edited to conform to the Board's arbitration rules, this pamphlet includes the text of rules G-35 and A-16, a glossary of terms and list of other sponsoring organizations.
1991 ..... no charge

**Instructions for Beginning an Arbitration**
Step-by-step instructions and forms necessary for filing an arbitration claim.
1991 ..... no charge

**The MSRB Arbitrator's Manual**
The Board's guide for arbitrators. Based on SICA's *The Arbitrator's Manual*, it has been edited to conform to the Board's arbitration rules. It also contains relevant portions of the *Code of Ethics for Arbitrators in Commercial Disputes*.
1991 ..... $1.00

## Reporter and Newsletter

**MSRB Reports**
The MSRB's reporter and newsletter to the municipal securities industry. Includes notices of rule amendments filed with and/or approved by the SEC, notices of interpretations of MSRB rules, requests for comments from the industry and the public and news items.
Quarterly ..... no charge

## Examination Study Outlines

A series of guides outlining subject matter areas a candidate seeking professional qualification is expected to know. Each outline includes a list of reference materials and sample questions.

**Study Outline: Municipal Securities Representative Qualification Examination**
Outline for Test Series 52.
November 1989 ..... no charge

**Study Outline: Municipal Securities Principal Qualification Examination**
Outline for Test Series 53.
July 1990 ..... no charge

## Brochure

**MSRB Information for Municipal Securities Investors**
Investor brochure describing Board rulemaking authority, the rules protecting the investor, arbitration and communication with the industry and investors. Use of this brochure satisfies the requirements of rule G-10.
1 to 500 copies ..... no charge
Over 500 copies ..... $.01 per copy

# Publications Order Form

| Description | Price | Quantity | Amount Due |
|---|---|---|---|
| MSRB Manual (soft-cover edition) | $5.00 | | |
| Glossary of Municipal Securities Terms | $1.50 | | |
| Professional Qualification Handbook | 5 copies per order no charge<br>Each additional copy $1.50 | | |
| Manual on Close-Out Procedures | $3.00 | | |
| Instructions for Filing Forms G-36 | no charge | | |
| Arbitration Information and Rules | no charge | | |
| Instructions for Beginning an Arbitration | no charge | | |
| The MSRB Arbitrator's Manual | $1.00 | | |
| Study Outline: Municipal Securities Representative Qualification Examination | no charge | | |
| Study Outline: Municipal Securities Principal Qualification Examination | no charge | | |
| MSRB Information for Municipal Securities Investors (Investor Brochure) | 1 to 500 copies no charge<br>Over 500 copies $.01 per copy | | |
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