MSRB
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Board's Offices to Move

The Board's Washington, D.C. offices will move soon. Watch for notice of the new address and date of move. The telephone number will remain (202) 223-9347.

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May 31, 1994 — Comments due on draft amendment to rule G-34

June 15, 1994 — Comments due to SEC on File No. S7-6-94

July 1, 1994 — Effective date of amendment to rule G-15(d)(ii)

July 15, 1994 — Comments due to SEC on File Nos. S7-4-94 and S7-5-94

Pending — Proposed rule G-37, on political contributions and prohibitions on municipal securities business
— Amendments to rules G-19 and G-8 relating to suitability of recommendations and related recordkeeping requirements

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Invest Wisely Brochure Available

On March 10, 1994, the Securities and Exchange Commission (SEC) and a group of 11 securities regulators, including the Board, launched a public awareness campaign to help investors better understand how to invest in stocks, bonds and other securities.

The regulators released a brochure, *Invest Wisely*, which provides basic information to help investors select a brokerage firm and salesperson, identify decisions to be made before making an initial investment decision, and address a problem that may arise. The brochure also helps investors identify questions they should ask, provides background information about the securities industry, and describes practices that may signal problems.

Invest Wisely is cosponsored by the SEC; North American Securities Administrators Association, Inc.; American Stock Exchange; Boston Stock Exchange; Chicago Board Options Exchange; Chicago Stock Exchange; Cincinnati Stock Exchange; Municipal Securities Rulemaking Board; Nasdaq Stock Market/National Association of Securities Dealers; New York Stock Exchange; Pacific Stock Exchange; and Philadelphia Stock Exchange.

The SEC and the regulators will distribute the brochure to the public at no charge. The public can call or write to the SEC and any one of the self-regulatory organizations to obtain a copy of the brochure. The regulators also are encouraging dealers to consider ways to help distribute *Invest Wisely*.

Staff Appointment

Denise P. Person has been appointed Director of Arbitration. Ms. Person has been with the Board since 1987. She was previously Arbitration Administrator.

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

T+3 Settlement for the Municipal Securities Market

On October 6, 1993, the Securities and Exchange Commission approved Securities Exchange Act Rule 15c6-1, announcing a national goal of shortening the standard settlement time frame for most types of securities transactions to three business days (T+3 settlement). The effective date of Rule 15c6-1 was set for June 1, 1995.

Recognizing the unique nature of the municipal securities market and the efforts that have been made by the Board in this area, the Commission did not include municipal securities within the scope of Rule 15c6-1. The Commission, however, did formally request that the Board undertake a commitment to T+3 settlement for municipal securities. The Commission also asked that, by April 1994, the Board provide a plan for implementing T+3 settlement in the municipal securities market.

Reprinted below is the correspondence between the Commission and the Board on this matter and the Board's Report on T+3 Settlement for the Municipal Securities Market.

March 17, 1994

Questions or comments about the Report may be addressed to Judith A. Somerville, Uniform Practice Specialist.

Letter from the Commission to the Board

October 7, 1993

David Clapp
Chairman
Municipal Securities Rulemaking Board
1818 N Street, N.W.
Suite 800
Washington, D.C. 20036

RE: *Three Day Settlement of Municipal Securities Transactions*

Dear Chairman Clapp:

Yesterday, the Commission took an important step to reduce systemic risk in securities markets by adopting, effective June 1, 1995, Rule 15c6-1 under the Securities Exchange Act of 1934, which will require broker-dealers to settle most securities transactions in three rather than five business days after trade date.

The Commission is encouraged by the commitment of the MSRB to the goal of moving the municipal securities market toward automated clearance and settlement, and in recognition of the MSRB's leadership in this area, the Commission determined not to include municipal securities within the scope of Rule 15c6-1. The Commission believes that it is essential that the municipal securities market continue to remain in step with the corporate bond and equity markets. Accordingly, we urge the MSRB to continue to work aggressively toward removing the remaining impediments to three-day settlement in the municipal securities market.

A number of steps will be necessary to achieve earlier settlement of municipal securities transactions, including operational changes and education. We are committed to working closely with the MSRB to achieve a shorter settlement timeframe for municipal securities. In an effort to move forward on this matter, please report to the Commission, within six months, on how the MSRB will achieve T+3 settlement for municipal securities transactions by June 1, 1995.

I look forward to our collaboration and cooperation. If you have any questions concerning this matter, please contact me or Brandon Becker, Director, Division of Market Regulation, at (202) 272-3000.

Sincerely,

Arthur Levitt
Chairman

Letter from the Board to the Commission

March 17, 1994

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W., Room 6010
Washington, D.C. 20549

Dear Chairman Levitt:

The Municipal Securities Rulemaking Board has reviewed your letter of October 7, 1993, on T+3 settlement and your request that the Board present the Commission with a plan for converting the municipal securities market to T+3 settlement. The enclosed Report is provided in response to your request. It describes the progress that the Board has made in the area of T+3 settlement and the Board's plans and timetable for reaching this objective in the municipal securities market.

Board Action to Support T+3 Settlement

Many of the actions necessary to prepare for T+3 settlement have already been taken. An 18-month implementation plan revamping the Board's automated clearance and settlement rules was adopted by the Board in September 1992, and the final phase of this plan was recently approved by the Commission.[1] When this rule change becomes effective in July 1994, Board rules will require essentially all inter-dealer and institutional customer transactions to be processed in automated clearance and settlement systems. In addition, through numerous published notices in *MSRB Reports* and meetings with industry groups, the Board has kept the municipal securities industry informed on the status of the Group of Thirty project in the United States and the efforts being undertaken to bring about T+3 settlement. Since the adoption of Rule 15c6-1, the Board has also been using these forums to emphasize the need for members of the municipal securities industry to begin preparations for the conversion to a shorter settlement cycle. The Board currently has underway a number of additional projects to prepare the municipal securities industry for T+3 settlement. These include a rule proposal aimed at making more new issues of municipal securities depository eligible and proposed enforcement initiatives to foster better compliance with the Board's automated clearance rules. One of the Board's primary objectives in these undertakings is to ensure a proper level of coordination with and among registered clearing agencies and the agencies responsible for enforcing Board rules. The Board also is working with industry groups to ensure that a high priority is given to the municipal securities market in the various industry-wide efforts to prepare for T+3.

Timing for Movement to T+3 Settlement of Municipal Securities

In terms of future actions, the Board plans to adopt specific rule changes that will require regular-way transactions in municipal securities to be settled on a T+3 basis. The Board believes that these rule changes will provide an appropriate corollary to Rule 15c6-1 in the municipal securities market. With respect to the timing for the rule changes, the Board fully understands and appreciates the need for the municipal securities industry to move in step with the corporate bond and equity markets. The Board accordingly expects to file rule changes with the Commission in time to allow the conversion of the municipal securities market to T+3 settlement to take place concurrently with the June 1995 effective date of Rule 15c6-1. However, successfully meeting this goal will depend on making progress over the next year in several areas. These are discussed in depth in the enclosed Report and are summarized below.

Issues in the Institutional Market

The municipal securities industry faces certain challenges in using automated clearance and settlement systems that are substantially different from those faced by exchange and NASDAQ markets. The primary problems that must be addressed in this respect are a low comparison rate in the inter-dealer market and a low acknowledgement rate by institutional customers. The Board expects that sufficient progress will be made over the next year to allow conversion to T+3 by June 1995. Nevertheless, the Board will emphasize to industry participants that work in these areas cannot be delayed and that failure to make progress over the next year will jeopardize timely and successful conversion to T+3 settlement in the municipal securities market.

Issues in the Retail Market

With respect to retail transactions, the Board notes that the securities industry in the United States has not yet found complete answers to all of the questions that have been raised concerning the retail investor in a T+3 environment. These questions relate both to customer payment mechanisms and the desire of retail customers to hold securities certificates. It appears to the Board that these issues apply more or less equally to both municipal and corporate securities transactions. The securities industry will be focusing on these problems over the next year through the efforts of several industry organizations. The Board intends to participate in and coordinate with these broad-based industry initiatives to ensure specific coverage of the retail market for municipal securities.

In addition to working with industry groups, the Board also hopes to work closely with the Commission in identifying and resolving retail customer issues that may arise in the conversion to T+3 settlement. Over the last year, the Board has been actively considering its customer confirmation rule and the timing and nature of written disclosures provided to customers in a T+3 environment. The Board would like to work with the Commission to ensure basic levels of consistency between Board rules and the rules of the Commission in this respect. As noted in the Report, the Board over the last year has been giving consideration to requiring retail customer confirmations to be sent on T+1 and requiring customer confirmations to be provided by facsimile

[1] Securities Exchange Act Release No. 34-33515 (January 24, 1994).

transmission if requested by the customer. In this connection, the Board also is considering whether it may be time to break away from the standard five-by-nine inch confirmation form and to require additional written disclosures to be provided to customers about the municipal securities they are purchasing.

* * *

The Board looks forward to working with the Commission to ensure successful conversion to T+3 settlement for municipal securities. Please do not hesitate to contact me if you have questions about the Board's objectives and plans in this area.

Sincerely,

David C. Clapp
Chairman

REPORT OF THE MUNICIPAL SECURITIES RULEMAKING BOARD ON T+3 SETTLEMENT FOR THE MUNICIPAL SECURITIES MARKET

I. INTRODUCTION

On October 6, 1993, the Securities and Exchange Commission (SEC or Commission) approved Securities Exchange Act Rule 15c6-1, announcing a national goal of shortening the standard settlement time frame for most types of securities transactions to three business days (T+3 settlement).[1] The effective date of Rule 15c6-1 was set for June 1, 1995.

Recognizing the unique nature of the municipal securities market and the efforts that have been made by the Municipal Securities Rulemaking Board (Board) in this area, the Commission did not include municipal securities within the scope of Rule 15c6-1.[2] The Commission, however, did formally request that the Board undertake a commitment to T+3 settlement for municipal securities.[3] The Commission also asked that, by April 1994, the Board provide a plan for implementing T+3 settlement in the municipal securities market.

Over the past several years, the Board has worked actively to bring about improvements in clearance and settlement of municipal securities in an attempt to reach parity with the corporate securities industry and to prepare for a possible move to T+3 settlement. These efforts have included several changes to the Board's rules, numerous meetings and correspondence with municipal industry groups and other educational efforts.[4] Since the adoption of Rule 15c6-1, the Board's staff also has maintained close communication with the Commission's staff to ensure that the Board's approach to T+3 settlement in the municipal market would be consistent with the approach being taken by the Commission.

This Report describes the status of the Board's current efforts and plans to implement T+3 settlement. There remain questions, however, on exactly how the municipal securities industry will respond to the challenges in this area. The Board will keep the Commission and the industry informed of the progress being made and any changes that may become necessary in the planned conversion of the municipal securities market to T+3 settlement.

II. OVERVIEW OF T+3 PLAN FOR MUNICIPAL SECURITIES

In the municipal market, the issues involved in moving to T+3 settlement divide broadly into those affecting institutional transactions and those affecting retail transactions. As used in this Report, the terms "institutional transactions" and "institutional market" refer both to transactions between brokers, dealers and municipal securities dealers (dealers) and transactions between dealers and institutional customers. In general, institutional transactions are settled on a Delivery versus Payment or Receipt versus Payment (DVP/RVP) basis, while retail transactions are not.

In a T+3 environment, timely settlement of institutional transactions will depend in large part upon efficient use of certain mandatory, centralized, automated systems for clearance and settlement. These automated systems are operated by clearing agencies registered with the Commission under section 17A of the Securities Exchange Act. As the Board has reported to the Commission on several occasions, the unique nature of the municipal securities market has made it difficult for industry members

[1] Securities Exchange Act Release No. 34-33023 (October 6, 1993) [hereinafter cited as *Rule 15c6-1 Adopting Release*].

[2] *Id.* at 3.

[3] Letter from Arthur Levitt, Chairman, SEC to David Clapp, Chairman, MSRB (October 7, 1993), reprinted above.

[4] Representatives of the Board have discussed T+3 settlement with representatives of the following groups since October 1993: the Legal and Regulatory Subgroup and the U.S. Working Committee of the Group of Thirty Project, the Clearance and Settlement Committee of the Securities Industry Association, the Operations and Compliance Committee of the Municipal Division of the Public Securities Association, the Regional Municipal Operations Association, the Association of Clearing House Banks of New York, the Cashiers' Association of Wall Street, the National Association of Securities Dealers, the Office of the Comptroller of the Currency, Depository Trust Company, Philadelphia Depository Trust Company, Midwest Securities Trust Company and National Securities Clearing Corporation.

The Board also has published a number of notices in *MSRB Reports* to inform municipal industry personnel of the status of the T+3 settlement project in the United States. *See, e.g.*, "Developments Concerning T+3 Settlement and Automated Clearance and Settlement Rules: Rules G-12 and G-15," *MSRB Reports*, Vol. 14, No. 1 (January 1994) at 17; "Letter to SEC on Its Proposed Rule on T+3 Settlement," *MSRB Reports*, Vol. 13, No. 2 (June 1993) at 11; "Proposed SEC Rule on T+3 Settlement," *MSRB Reports*, Vol. 13, No. 2 (April 1993) at 3; "Group of Thirty U.S. Working Committee Status Report & Request for Comment," *MSRB Reports*, Vol. 10, No. 4 (October 1990) at 11.

to use some of these systems with the same efficiencies enjoyed in the corporate securities markets.[5] Making these automated clearance systems work with the efficiency necessary for a three-day settlement cycle will require a concerted effort by dealers and institutional customers. In addition, the clearing agents and service bureaus that process municipal transactions may need to make changes in their systems and practices.

The issues involved in moving the retail securities market to T+3 settlement primarily involve mechanisms for communicating with, obtaining payment from, or changing the behavior of individual investors. There are two central questions in this respect: (i) how (and whether) retail customers will pay by T+3 when they purchase securities; and (ii) how retail customers who hold securities certificates will settle by T+3 when they sell their securities. While the institutional market challenges are, for the most part, unique to municipal securities, these retail market issues generally are the same for both corporate and municipal securities.

The T+3 settlement issues in the retail market may present the securities industry, in general, with more problems than the issues involving institutional transactions. However, municipal securities dealers will not be able to focus on payment mechanisms and customer education programs aimed at retail customers if a T+3 settlement cycle is causing increasing numbers of failed transactions on the institutional side of the market. For this reason, the Board believes that it is critical for the municipal securities industry to resolve clearance and settlement issues in the institutional market prior to the conversion to T+3 settlement. This Report provides specific plans on how this can be done.

The Board's overall plan is that the municipal securities industry should work aggressively over the next year to achieve more efficient use of automated clearance and settlement systems, similar to that already achieved in the corporate securities market. Concurrently, the Board will work with securities industry organizations, and with the SEC, to ensure that broad-based retail customer education programs, customer payment mechanisms and other retail sector T+3 initiatives include, and are responsive to, the retail market in municipal securities.

The Board's current intention is to convert the municipal securities market to T+3 settlement at the same time as this is done for those securities within the scope of Rule 15c6-1. However, successfully meeting this goal depends upon the success of industry efforts, over the next year, to improve the use of automated clearance and settlement systems. Discussed below are more specific plans for addressing both the institutional and retail aspects of T+3 settlement in the municipal securities market.

III. INSTITUTIONAL TRANSACTIONS

The Board believes that the key to bringing about a successful conversion to T+3 settlement in the institutional market is the efficient use of existing automated clearance and settlement systems. For the municipal securities market, the systems most critical are those that provide processing for: (i) comparison of inter-dealer transactions; (ii) confirmation/acknowledgement of institutional customer transactions; and (iii) book-entry settlement.[6] Since 1983, the Board has worked to include municipal securities transactions within those systems to the maximum extent feasible.[7] Although the transition to automated systems has been more difficult for the municipal securities market than for corporate securities, the Board believes that the full efficiencies of the automated systems are now within reach.

A. Characteristics of the Municipal Securities Market Affecting Clearance and Settlement

As the Commission has noted, substantial efficiencies have been derived from the use of automated clearance and settlement systems in the corporate securities markets.[8] There are, however, several characteristics of the municipal securities market that distinguish it from corporate equity markets and affect the relative efficiencies derived from automated clearance and settlement systems.

One of the distinguishing features of the municipal securities market is the number of outstanding issues. The most recent estimates from the CUSIP Service Bureau indicate that there are approximately 1.2 million municipal securities with assigned CUSIP numbers.[9] Each of these securities is a distinct, non-fungible entity for purposes of trading, clearance and settlement. All

[5] *See, e.g., Prospects for Automation of Municipal Clearance and Settlement Procedures, A Report to the Securities and Exchange Commission* (MSRB 1983) [hereinafter cited as *1983 Report*], at 11-22; *Automated Clearance and Settlement in the Municipal Securities Market, A Report to the Securities and Exchange Commission* (MSRB 1988) [hereinafter cited as *1988 Report*], at 17-23. The Board also discussed the unique features of the municipal securities market in its comment letter on then proposed SEC Rule 15c6-1. *See* Letter from Charles W. Fish, Chairman, MSRB to Jonathan G. Katz, Secretary, SEC (May 17, 1993).

[6] A netting system also is used in the municipal securities market and is responsible for timely and efficient settlement of many inter-dealer transactions. Participation in the system, which is operated by National Securities Clearing Corporation (NSCC), is voluntary for dealers—unlike the other automated systems which are required to be used under Board rules G-12(f) and G-15(d). The netting system remains voluntary because: (i) not all municipal securities dealers are (or desire to be) full clearing members of NSCC; and (ii) the mandatory acceptance of partial deliveries, which is a prominent feature of the netting system, creates unique problems in the municipal securities market. *See* section III.A., *infra*. For a more complete discussion of the "partials" issue, see "Open Inter-Dealer Transactions: Rule G-12," *MSRB Reports*, Vol. 13, No. 1 (January 1993) at 7.

[7] *See 1983 Report; 1988 Report.*

[8] *See, e.g., Rule 15c6-1 Adopting Release* at 22-23.

[9] The Board believes that the great majority of outstanding municipal securities have CUSIP numbers assigned. CUSIP numbers are essential for processing transactions in automated clearance and settlement systems. Board rule G-34 accordingly requires underwriters to obtain CUSIP number assignment for a new issue if the issue is eligible for number assignment under the criteria used by the CUSIP Service Bureau. In February 1993, the Board asked the Board of Trustees for the CUSIP Agency to change these criteria to allow the Service Bureau to assign numbers to certain small municipal issues that previously had been ineligible. The CUSIP Board responded affirmatively, thus removing the last substantial exception to the general requirement that new municipal issues receive CUSIP numbers. *See* "CUSIP Number Eligibility Standards and Requirement to Obtain CUSIP Numbers: Rule G-34," *MSRB Reports*, Vol. 13, No. 2 (April 1993) at 15-16.

organizations involved in clearing and settling municipal securities—including dealers, registered clearing agencies and service bureaus—must have the necessary information and systems capability to process a transaction in any one of these 1.2 million securities on any given day. Compared to the much smaller universe of corporate securities that are traded on exchanges or NASDAQ, (approximately 10,000) the large number of municipal securities add time, cost and effort to automated processing requirements.

Another major difference between corporate and municipal securities markets is the emphasis on primary market activity. In 1993, for example, over $289 billion in long-term new municipal debt issues were brought to market. These 13,916 new issues created approximately 140,000 new securities when the individual maturities of each issue are counted.[10] For each of these securities, information such as CUSIP number, interest rate, maturity date, and other details must be obtained and entered into automated systems before any clearance or settlement can begin. Although "setting up" these new municipal issues in automated systems is relatively time consuming and expensive, it is extremely important since much of the trading activity in the municipal market revolves around new issues.

Non-standard features and conditions of some municipal securities also may create inefficiencies in automated clearance and settlement. Over recent years, securities depositories have spent a considerable amount of effort in changing their systems to accommodate various novel features of municipal issues and to accommodate different conditions that may affect the clearance and settlement of a municipal issue.[11] Unlike the exchange-listed and NASDAQ markets, where listing standards can be used to help standardize securities for efficiency of clearance and settlement, there is no similar regulatory mechanism in the municipal securities market.[12]

Finally, the tax-exempt nature of municipal securities sometimes contributes to unique situations that affect clearance and settlement. For example, tax-exemption, along with thin markets, discourages dealers from borrowing municipal securities when necessary to make deliveries—a routine practice in the corporate markets. This, in turn, affects the ability and willingness of municipal securities dealers to accept partial deliveries, which is a necessary by-product of transaction netting systems.[13] Thus, while many dealers voluntarily participate in a netting system for certain types of municipal securities transactions,[14] netting is not used to the same extent as in the corporate securities markets.

Notwithstanding the unique characteristics of the municipal securities market, much progress has been made in the last several years toward bringing a higher proportion of municipal securities transactions into automated clearance and settlement systems. The Board believes that the municipal securities market is now close to the corporate securities market in this respect. The remaining challenges for municipal securities relate primarily to more efficient use of the systems, particularly in terms of timely and accurate submission of information by dealers, institutional customers and their clearing agents.

B. Comparison of Inter-Dealer Transactions

Automated comparison is the process by which each party to an inter-dealer trade ensures that its contra-party knows the terms of the trade and will be ready to settle, on those terms, on settlement date.[15] Board rule G-12(f)(i) requires each inter-dealer transaction to be submitted for automated comparison if the transaction is eligible in an automated comparison system. National Securities Clearing Corporation (NSCC) is the central facility for comparison processing.[16]

Since the comparison process is designed to facilitate timely and reliable settlements, efficient use of the system will be extremely important in a shortened settlement cycle. In August 1993, NSCC implemented a new comparison system for municipal securities under which trade data is compared on the evening of trade date and the results reported back to dealers on T+1—a one-day acceleration of the old comparison process.[17] This new system, which the Board supported through rule changes[18] and through coordination with NSCC in the development process, has moved the municipal securities industry one step closer to T+3 settlement. Under the new system, when both parties to an inter-dealer transaction submit their trade information to NSCC in a

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[10] *See* "Market Statistics," *The Bond Buyer*, (January 6, 1994) at 24. The number of different securities is based on an estimated average of 10 maturities per issue.

[11] *See, e.g.*, "In Response to Participants' Requests, DTC will Accommodate Baby Bonds," *DTC Newsletter*, (March 1993); "Deposits with Letters of Correction Now Handled As Regular Deposits," *DTC Newsletter*, (February 1993); "Non-Transferrable Securities Become Eligible for Deposit," *DTC Newsletter*, (January 1993) and "DTC Reclamation Procedure Helps Reduce Number of Call-Related Short Positions," *DTC Newsletter*, (November, 1992).

[12] *Cf. Rule 15c6-1 Adopting Release* at 24 (discussion of possible listing requirement to ensure depository eligibility of NASDAQ and exchange-listed securities).

[13] For a discussion of the "partials" problem, see "Open Inter-Dealer Transactions: Rule G-12," *MSRB Reports*, Vol. 13, No. 1 (January 1993) at 7; "Open Inter-Dealer Transactions: Rule G-12," *MSRB Reports*, Vol. 12, No. 1 (April 1992) at 37.

[14] *See generally* Securities Exchange Act Release No. 34-20795 (March 28, 1984) (describing netting system operated by National Securities Clearing Corporation).

[15] In general, the comparison process requires each dealer in a transaction to submit information on a trade (*e.g.*, price, quantity, contra-party, etc.) to a comparison system operated by a clearing agency registered with the SEC. This information is then matched (compared) by computer in the comparison system and the results reported back to each dealer.

[16] NSCC is a clearing agency registered with the SEC.

[17] *See* Exchange Act Release 34-32747 (August 13, 1993).

[18] Effective August 1993, the Board amended rule G-12(b) to require managing underwriters to notify a registered clearing agency offering comparison services of the settlement date of a new issue as soon as it is known (and immediately upon any change in the settlement date). This amendment was designed to allow NSCC to calculate final monies for when-issued transactions and thus improve the comparison process for those transactions. *See* Exchange Act Release 34-32594 (July 7, 1993).

timely and accurate manner, each party is able to obtain a record from NSCC on T+1 that the contra-party knows the trade on the same terms (a "comparison").[19]

The Board, however, is concerned about the relatively low percentage of trades that actually do "compare" on the night of trade date. Currently, only 76% of trade submissions received by NSCC result in compared trades in the initial comparison cycle which is reported to dealers on T+1. The remaining 24% of trade submissions represent trades in which one or both parties either failed to submit the trade or failed to do so accurately. Each dealer must then expend additional effort on T+1 to: (i) determine why there was no comparison (*e.g.*, by calling the contra-party); (ii) follow certain additional procedures, through NSCC, to obtain comparison if there is, in fact, a trade; and (iii) monitor the reports received from NSCC on T+2 to ensure that the uncompared trade submission has been appropriately updated in the comparison system.

In a T+5 settlement environment, dealers have the necessary time to manage the existing number of uncompared trades; there is no indication that the low comparison rate currently causes inter-dealer trades to fail to settle on time. In a T+3 environment, however, the low comparison rate and the need to remedy numerous uncompared trades on T+1 may cause serious problems, especially if high volume or other operational difficulties should prevent a dealer from addressing all uncompared trades on T+1.

The Board is taking several actions to address the low comparison rate prior to conversion to T+3 settlement. Board representatives are emphasizing the need for improvements in the comparison rate at every opportunity with industry organizations. The Board also is working with the agencies responsible for enforcement of Board rules to arrange for a special enforcement effort on rule G-12(f)(i). The Board has asked NSCC to participate in this effort by sharing with enforcement agencies certain information about dealer performance in the comparison system. The Board expects that this program will result in specific enforcement actions against dealers who are not submitting transactions in a timely and accurate manner and who are causing the low comparison rate.

C. Confirmation/Acknowledgement of Institutional Customer Transactions

The confirmation/acknowledgement process is designed to ensure timely settlement of institutional customer transactions. This is done by obtaining an acknowledgement from the institutional customer (or the customer's agent) of a trade confirmation sent by a dealer. Both confirmation and acknowledgement are processed through an automated confirmation/acknowledgement system operated by a clearing corporation registered with the SEC.[20] Depository Trust Company (DTC) is the central processing facility for the automated confirmation/acknowledgement process for municipal securities.[21] The confirmation/acknowledgement process used for municipal securities is essentially the same as that for corporate securities.

A confirmation/acknowledgement system automates many of the settlement-related communications that must take place among a dealer, an institutional customer and the customer's clearing agent. In a three-day settlement cycle, the available time for such communications will be substantially reduced and thus the dependence on confirmation/acknowledgement systems to achieve timely settlement will be increased. DTC currently is working on several enhancements to its confirmation/acknowledgement system to provide a means for quicker acknowledgements and otherwise to improve system performance.[22]

The Board believes that substantial improvements are needed in the use of automated confirmation/acknowledgement systems in the municipal securities market before T+3 settlement can be achieved. The needed improvements relate to transactions that are not being submitted to a confirmation/acknowledgement system by dealers and to transactions that are being submitted, but that are not acknowledged by the customer or the customer's agent.

Board rule G-15(d)(ii) currently states that, with certain exceptions, a dealer shall not grant DVP/RVP privileges to a customer unless the transaction is processed in an automated confirmation/acknowledgement system. To ensure more complete coverage, the Board recently amended the rule to remove most of the exceptions.[23] After this amendment becomes effective on July 1, 1994, all DVP/RVP transactions with institutional customers will have to be processed in automated confirmation/acknowledgement systems if the securities have an assigned CUSIP number.

The Board believes that there may be a number of transactions that are not being submitted to an automated confirmation/acknowledgement system in violation of rule G-15(d)(ii).[24] Based on information it has developed, DTC also believes that some dealers simply are not using the systems to the fullest extent possible.[25]

[19] The comparison process is slightly different for trades by syndicate managers with syndicate members. In those transactions, only the syndicate manager need submit transaction information for comparison.

[20] Midwest Securities Trust Company (MSTC) and Philadelphia Depository Trust Company (PHILADEP) are linked to DTC's confirmation/acknowledgement processing system to permit interfacing among DTC, MSTC and PHILADEP members.

[21] DTC is registered with the SEC as a clearing agency for this purpose.

[22] *See, e.g., Institutional Delivery (ID) System Functional Design Paper for Enhanced, Interactive Capabilities* (Depository Trust Company 1993). When completed, this system change will allow institutional customers and their agents to acknowledge transactions through an interactive matching process, rather than waiting a day for a confirmation to appear after it is sent by a dealer.

[23] *See* Securities Exchange Act Release 34-33515 (January 24, 1994). The amendment eliminates the exception for transactions involving parties that are neither members of a depository offering confirmation/acknowledgement services nor use a clearing agent for the transaction that is a member of such a depository.

[24] Some dealers have reported that, for some institutional customers, they do not submit transactions to a confirmation/acknowledgement system even though they settle with the customers by book-entry. These transactions represent violations of rule G-15(d)(ii) in its current formulation.

[25] Letter from Richard Bednarz, Director, DTC, to Harold Johnson, Deputy General Counsel, MSRB (January 21, 1994). DTC indicates that as many as 1,250 institutional customer transactions in municipal securities per day are being settled by book-entry without previously being submitted to a confirmation/acknowledgement system.

In addition, there are large numbers of transactions that are submitted by dealers to a confirmation/acknowledgement system, but that are not acknowledged by customers. The overall acknowledgement rate for municipal securities eligible for deposit at DTC is approximately 82%. This compares to a 96% rate in the corporate securities market. Since the current 82% municipal rate relates to acknowledgements received by T+3, and since a three-day settlement cycle will require acknowledgement much earlier than this, the Board believes that a substantial amount of improvement is needed before the municipal securities industry can move to T+3 settlement.[26]

The Board is working with depositories and industry organizations to improve the use of confirmation/acknowledgement systems for municipal securities.[27] Several industry groups also have come forward to help address this problem. The Public Securities Association has indicated that a T+3 task force will be created and will address the affirmation rate. The Board also has received offers of assistance in this area from the Securities Industry Association's Clearance and Settlement Committee, the Cashiers' Association of Wall Street, Inc., and the Regional Municipal Operations Association. These industry organizations will help to ensure that the dealer community is fully aware of the importance of submitting confirmations of municipal securities transactions through automated confirmation/acknowledgement systems. At this time, it appears that there also is a need for significant educational work to be done with institutional customers and their clearing agents to make clear the importance of participating in an automated confirmation/acknowledgement system and the importance of acknowledging municipal securities transactions sent through such systems.

The Board will be encouraging these industry efforts and also will continue to work with the securities depositories to help outline potential solutions. With respect to those dealers that are not submitting transactions to an automated confirmation/acknowledgement system in violation of Board rule G-15(d)(ii), the Board anticipates that an enforcement initiative may be needed similar to that described above with respect to automated comparison. The Board believes that it may be appropriate for that enforcement initiative to begin concurrently with the July 1994 effective date of the amendment to rule G-15(d)(ii).

D. Book-Entry Settlement and Depository Eligibility

It will be difficult—or even impossible—for dealers and institutional customers to make timely T+3 settlements with deliveries of physical certificates against payments of money (*i.e.*, physical DVP/RVP settlements). To minimize the incidence of failed transactions in these situations, it will be important that institutional transactions be settled by book-entry to the greatest extent possible.

Board rules G-12(f)(ii) and G-15(d)(iii) already require book-entry settlement of institutional transactions in depository-eligible securities.[28] These rules also provide an incentive for institutional customers and dealers to leave certificated securities on deposit at a depository, which will help to ensure timely settlements by T+3. However, rules G-12(f) and G-15(d) apply only to securities that are depository-eligible at the time of settlement.[29] There currently is no requirement for underwriters or issuers to make municipal securities issues depository-eligible.

The Board is aware that efforts are underway by the Self-Regulatory Organizations governing exchange-listed and NASDAQ securities to mandate depository eligibility of the securities traded in those markets.[30] Because of the increased importance of book-entry settlement in a T+3 environment, the Board also is reviewing whether there is a need for regulatory action to help ensure that new issue municipal securities are made depository-eligible.

1. Depository Eligibility of Outstanding Issues

The Board has asked each of the three depositories processing municipal securities for information on the current status of depository eligibility of municipal securities.[31] The following assessment is based upon information provided by the depositories.

[26] The low affirmation rate for some institutional customers may help to explain non-submissions by dealers. Some dealers have stated that they tend to discontinue sending confirmations through an automated system to customers who routinely do not acknowledge transactions through the system.

[27] At the Board's request, DTC has identified some of the major causes for transactions that are not acknowledged. Some of these reasons relate to coding problems that may be addressed in a new "Standing Instructions Data Base" that DTC plans to implement in the future. However, these coding problems do not explain the substantial differences in the municipal and corporate acknowledgement rate. Letter from Richard Bednarz, Director, DTC to Judith Somerville, Uniform Practice Specialist, MSRB (December 10, 1993).

[28] The Board amended rule G-12(f)(ii), effective January 4, 1993, to require that all inter-dealer transactions in depository-eligible securities be settled by book-entry delivery. This amendment eliminates prior exemptions for: (i) transactions that were not compared in an automated comparison system; and (ii) transactions involving dealers who are not members of a depository. *See* Securities Exchange Act Release No. 34-31645 (December 23, 1992). A similar amendment was made to rule 15(d)(iii), effective July 1, 1993, to require all DVP/RVP customer transactions in depository-eligible securities to be settled by book-entry, with two limited exceptions. The requirement for book-entry settlement does not apply if securities involved in a transaction are ineligible at a depository used exclusively by one of the parties to the transaction. Additionally, a dealer may effect a physical RVP settlement with an issuer or trustee if the issuer or trustee is purchasing securities for the purpose of retiring them. *See* Securities Exchange Act Release No. 34-32640 (July 15, 1993).

[29] It is possible for an issue to be made depository-eligible after a trade (but prior to settlement) in the secondary market. As discussed, *infra*, depositories operate programs designed to do this, using trade data received from various sources. When a security is made depository-eligible between trade date and settlement date, a book-entry settlement is required under Board rules. Making issues depository-eligible in this manner helps to assure timely, book-entry settlement for any future trades in the issue.

[30] *See Rule 15c6-1 Adopting Release* at 24.

[31] Letters from Harold Johnson, Deputy General Counsel, MSRB to: Richard Nesson, Executive Vice President and General Counsel, DTC (December 10, 1993); Sharon Metzker, Compliance Counsel, Philadelphia Depository Trust Company (January 5, 1994); and Larry A. Mallinger, Compliance Counsel and Compliance Officer, Midwest Securities Trust Company (January 5, 1994).

With respect to the municipal securities outstanding, it appears that a high percentage already are depository-eligible (*i.e.*, the securities are listed as eligible on a depository's eligible securities list).[32] DTC alone estimates that, in terms of par value, it currently holds (and thus makes eligible) approximately 96% of all municipal bond issues outstanding. Moreover, DTC also believes that, of the new municipal issues coming to market each year, 96.8% of the par value is made eligible at DTC prior to initial distribution and is distributed via book-entry through DTC.[33]

With respect to numbers of issues (contrasted to par value), the situation is less clear. DTC lists as eligible approximately 1.023 million of the estimated 1.2 million municipal CUSIP numbers outstanding. DTC also believes that, of the remaining 177,000 CUSIP numbers, approximately 100,000 represent securities that, in reality, are not outstanding, such as called issues or cancelled CUSIP numbers that have not been removed from the master CUSIP list. Thus, DTC believes that only approximately 77,000 CUSIP numbers should be considered in determining outstanding municipal securities that are not DTC-eligible. While a few of these issues may be eligible at other depositories, it should be noted that DTC and Midwest Securities Trust Company (MSTC) undertake to make an issue mutually eligible whenever the issue meets the eligibility criteria of both depositories.[34]

DTC indicates that it is performing a review of outstanding municipal securities issues that are not DTC-eligible and that all issues not listed as eligible will be reviewed for eligibility by mid-1995. This review project, which makes municipal securities eligible based upon participant requests, trade comparison data and listings of issues contained in the CUSIP Directory, has resulted in over 100,000 outstanding municipal securities being made depository-eligible since July 1992.

2. Draft Amendment to Rule G-34 on Depository Eligibility for New Issues

Although there are programs in place which result in the review of outstanding municipal securities for depository eligibility, the Board believes that there may be a need for additional measures to address the number of new issues that are coming to market without being made depository-eligible at initial issuance. Since underwriters are not required to apply to a depository to make a new issue eligible, the settlement and initial distribution of some new issues now occurs in the institutional market via deliveries of securities certificates, rather than via book-entry settlements at a depository.[35] DTC reports that approximately 2,000 new municipal securities come to market each month that are not made eligible at DTC.[36] The Board believes that the great majority of these issues could be made depository-eligible if a request were made by an underwriter.

Sales of new issue municipal securities take place on a "when, as and if issued" (when-issued) basis and are not considered "regular-way" trades. Settlement of when-issued trades do not now take place in a T+5 time frame and the Board does not contemplate that they would take place in a T+3 time frame after the conversion to T+3 settlement.[37] Since the period for settling a when-issued trade generally is more than five business days, a new issue distribution made with securities certificates probably would not directly result in failed transactions, even after conversion to T+3 settlement for regular-way trades.[38] Nevertheless, there are significant advantages to having an issue made depository-eligible at issuance. For example, the issue would be subject to rules G-12(f)(ii) and G-15(d)(iii) for the entire life of the issue, thus promoting timely T+3 settlement in the secondary market. In addition, it is sometimes possible for depositories, underwriters and issuers to work together to structure a new issue containing novel features so that it can be made depository-eligible. This flexibility may be available if depository eligibility is considered early in the underwriting process, but generally is not possible in the secondary market, after the security has been issued.

To minimize the number of non-depository-eligible issues that are created in the future, the Board is proposing for comment a draft amendment to Board rule G-34.[39] Rule G-34 currently states that an underwriter must obtain CUSIP numbers and take certain other actions with respect to a new issue to ensure that the issue can be processed in automated clearance and settlement systems. The draft amendment would add the requirement for underwriters also to apply for depository eligibility for a new issue at least 10 days prior to the closing date for the issue. This would provide adequate time for a depository to make the issue eligible prior to the initial distribution of the issue.[40]

The draft amendment would not require an underwriter to apply to a depository if an issue does not meet the eligibility criteria of the depository. Because the Board's regulatory authority is limited to dealers, it cannot require issuers to structure their issues

[32] In discussions of depository eligibility of municipal securities, it is important to distinguish between two basic reasons for a security not to be listed as eligible at a depository. Some issues that are not currently listed as eligible may have features or other conditions that do not meet the depository's eligibility criteria. For example, the issue may have a provision that requires that securities be called, as funds become available, in order of certificate number. Other municipal securities issues are not listed as eligible even though they do conform to all depository operational requirements. These issues could easily be made "depository-eligible" if a request were made by a depository participant.

[33] When a new issue is made depository-eligible prior to the initial distribution that occurs at closing, Board rules G-12(f)(ii) and G-15(d)(iii) operate effectively to require a book-entry distribution to all institutional customers and dealers purchasing the issue.

[34] *See, e.g.*, Letter from Larry A. Mallinger, MSTC, to Harold L. Johnson, MSRB (February 10, 1994).

[35] This discussion of book-entry distribution of new issues relates only to the institutional market and assumes that new issues may be either in certificated or Book-Entry-Only form. The availability of certificates to customers (and retail customer issues in general) are discussed in section IV., *infra*.

[36] Letter from Richard Nesson, Executive Vice President and General Counsel, DTC to Harold Johnson, Deputy General Counsel, MSRB (January 20, 1994). Some of these securities may be distributed by book-entry through other depositories, but the Board understands that many are being distributed with physical certificates.

[37] *See* section V., *infra*.

[38] Of course, failed transactions can result if a widely distributed new issue is settled physically and then is immediately the subject of secondary market trading before a depository can make the issue eligible.

[39] *See* "Requirement for Underwriters to Apply for Depository Eligibility," *MSRB Reports*, Vol. 14, No. 2 (March 1994).

[40] The Board requested comment on this timetable from each of the depositories processing municipal securities deliveries and each found the timetable satisfactory.

to meet depository eligibility criteria. Based on information from depositories, however, it appears that most new issues of municipal securities already meet depository operational requirements.[41] If this turns out not to be the case in the future, the Board may assess the need for some other mechanism (*e.g.*, voluntary standards and educational programs for financial advisors, issuers and underwriters) to address the issuance of municipal securities that cannot be processed in securities depositories.

The draft amendment would not require underwriters to apply for depository eligibility for issues under $1 million in par value. Some underwriters have suggested that, for a small issue with a limited initial distribution, the costs of a book-entry distribution are higher than the costs of a physical distribution. The exemption would allow underwriters of small issues to choose physical distribution if they judge this to be cost-effective in their particular situation. However, issues over $1 million—which are more likely to be subject of trading in the secondary market at some point during the life of the issue—would be subject to the requirement even if the initial distribution of the issue is limited to a few investors.

In its Request for Comment on the draft amendment, the Board is asking for comment on a variety of questions, including the need for the requirement, the need for an exemption for small issues, the appropriate threshold for the small issue exemption, and applicability of the requirement to short-term issues. The Board expects to review comments on the draft amendment in July 1994.

3. Uniform Depository Eligibility Lists

The reliance on book-entry settlement in a T+3 environment will place increasing importance on uniform depository eligibility lists. For example, if a specific municipal security is eligible at Depository A but not at Depository B, and then is traded between a member of Depository A and a member of Depository B, the interfaces between the depositories cannot be used and the transaction must be settled with a physical delivery.[42] The Board first identified this as a concern in its 1988 Report to the Commission on automated clearance and settlement of municipal securities.[43] Since that time, significant progress has been made on making eligibility lists uniform.[44]

While the Board is encouraged by the progress that has been made in this area, it also notes that even greater uniformity of depository eligibility lists may be desirable in a T+3 environment. For example, if the amendment to rule G-34 on depository eligibility is adopted, there may be a question about its application in a situation in which a new issue would be eligible at one depository but ineligible at others. The Board is asking for comment on this issue in its Request for Comment on the draft amendment to rule G-34, discussed above. If non-uniform depository eligibility criteria present a problem in a T+3 environment, the Board may ask the Commission to review this issue in connection with the Commission's oversight role with respect to registered securities depositories.

E. Same-Day Funds Settlement Convention

T+3 settlement in the institutional market may also be affected by the adoption of a same-day funds payment convention. This goal, which applies to all securities payments in the institutional markets, was included in the original recommendations of the Group of Thirty, along with the goal of T+3 settlement.[45]

Pursuant to a request by the U.S. Working Committee for the Group of Thirty project in the United States, DTC and NSCC have developed proposals for use of a same-day funds payment convention in their settlement systems. This would change the "next-day" funds convention now used for many settlements within these organizations.[46] The Board believes that most dealers and institutional customers would not be adverse to a same-day funds settlement convention as long as both their disbursements and receipts of funds are made in this form. In fact, DTC and NSCC indicate that their proposals on same-day funds payment generally have been well received by the industry.[47] There has been some difficulty, however, in arriving at a method for dealing with principal and interest payments made by debt issuers, and their paying agents, to depositories.

The crux of the "principal and interest" problem is that some debt issuers, particularly municipal securities issuers, apparently have factored the "next-day" funds payment convention into the compensation schedules for their paying agents.[48] In April 1993, a Same-Day Funds Task Force, including representatives from various sectors of the securities industry, was formed to address the "principal and interest" problem. The Task Force made several recommendations, primarily involving changes in depository

[41] *See* Letter from Richard Nesson, Executive Vice President and General Counsel, DTC to Harold Johnson, Deputy General Counsel, MSRB (January 20, 1994); letter from Larry A. Mallinger, Compliance Counsel and Compliance Officer, MSTC to Harold Johnson, Deputy General Counsel, MSRB (February 10, 1994).

[42] The potential for this situation prompted the Board to include certain language in its recent amendments to rules G-12(f)(ii) and G-15(d)(iii) stating that a book-entry delivery is not required under these circumstances. *See* Securities Exchange Act Release Nos. 34-31645 (December 23, 1992) and 34-32640 (July 15, 1993). Without this exemptive language, the rules effectively would require a dealer to be a member of all depositories to ensure the capability to make a book-entry settlement in such a situation.

[43] *See 1988 Report* at 22.

[44] DTC, for example, indicates that only 200 municipal securities issues are eligible at MSTC and ineligible at DTC. Letter from Richard Nesson, Executive Vice President and General Counsel, DTC to Harold L. Johnson, Deputy General Counsel, MSRB (January 20, 1994).

[45] *See* Group of Thirty, *Implementing The Group of Thirty Recommendations in the United States* (November 1990).

[46] "Next-day" funds are payments that will be available in "same-day" funds on the following business day.

[47] *See* Memorandum, Same-Day Funds Settlement System Conversion, The Depository Trust Company and National Securities Clearing Corporation (July 26, 1993).

[48] For example, the issuer and the paying agent may have agreed in a trust indenture or other document that the "float" involved in an interest or principal payment (resulting from the issuer's liability to its agent in same-day funds and the paying agent's liability to the depository in next-day funds) will accrue to the paying agent's benefit and will be part of the paying agent's compensation.

procedures governing the payment of interest and principal to depositories.[49]

In December 1993, the Board was requested to provide an endorsement of the recommendations of the Task Force.[50] The Board has provided a general endorsement of the principle of a uniform, same-day funds payment convention.[51] The Board noted, however, that it does not have jurisdiction to bring about payment in same-day funds by municipal issuers or their paying agents. The Board also noted that the recommendations of the Task Force failed to include any indication as to what steps might be taken by a depository if an issuer or paying agent were to refuse to provide same-day funds pursuant to depository procedures that may be adopted in the future.

The Board also wishes to note that retail transactions will not be subject to the same-day funds payment convention. As indicated in its comment letter on Rule 15c6-1, the Board believes that this may create additional financing costs for those dealers with large numbers of sales to retail customers.[52] Since these dealers will be required to pay same-day funds for all purchases on the inter-dealer market, but may not receive same-day funds from the retail customer, additional financing costs may result to dealers as a result of the conversion to a same-day funds payment convention.

IV. RETAIL TRANSACTIONS

In the Board's view, there remain significant questions about how T+3 settlement will be implemented with respect to the retail securities market and the effect that the conversion to T+3 settlement will have on that market. These questions revolve around two basic issues that are the same for both municipal and corporate securities: (i) how and whether retail customers will make payment to dealers by T+3; and (ii) how, and within what time-frame, retail customers holding securities certificates will be able to deliver those certificates to dealers to settle their transactions.

With respect to the first question on payment by T+3, the Board is aware that there are various means for money to be provided by customers in time for dealers to receive the funds by T+3. The most obvious method by which this may be done is for the customer to maintain some type of cash management arrangement with the dealer and to leave funds on deposit with the dealer for purchases of securities. The Board also is aware of industry efforts to implement an electronic payment system that could be used by retail customers to pay dealers by T+3.[53] The Board nevertheless believes that a significant part of the retail market for municipal (as well as corporate) securities consists of customers who pay for transactions by check.[54] Changing this practice (which, in some cases, is a strong customer preference) may be difficult. On the other hand, unless the practice can be altered to provide payment to dealers by T+3, dealers will incur substantial financing costs in servicing these retail customers.[55] Thus, while the effect of T+3 settlement on the retail market remains unclear, one result may be that dealers will pass on certain additional financing costs to retail customers.

With respect to sales of securities certificates held by retail customers, the situation that is most often cited as a concern is a dealer buying securities from a customer on trade date "T," and then executing an offsetting sale of the securities "to the street," also on T. The dealer in this case generally will be obligated to deliver the securities by book-entry on T+3. However, if the customer is holding physical certificates on T, it will be difficult or impossible for the dealer to obtain those certificates from the customer, deposit them and make a book-entry delivery "to the street" by T+3.

The Board is aware that retail customers and dealers have several options to avoid this situation. For example, the dealer (or its clearing broker or clearing agent) could offer safekeeping services to the customer. The Board believes that most dealers who are actively selling municipal securities offer this service to customers, either directly or through an intermediary.[56] Notwithstanding the progress that has been made in this area, there remain some retail customers who, for various reasons, insist on holding physical certificates. One option for addressing these situations would be an internal dealer policy that requires customers to present certificates to the dealer prior to the dealer accepting a sell order from the customer.

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[49] *See* Report of the Same-Day Funds Payment Task Force to the U.S. Working Committee (U.S. Working Committee for the Group of Thirty 1993) at 3-4.

[50] Letter from Richard Nesson, Executive Vice President and General Counsel, DTC to Harold Johnson, Deputy General Counsel, MSRB (December 23, 1993).

[51] Letter from Harold Johnson, Deputy General Counsel, MSRB to Richard Nesson, Executive Vice President and General Counsel, DTC (February 28, 1994).

[52] Letter from Charles W. Fish, MSRB, to Jonathan G. Katz, SEC (May 17, 1993) (File No. S7-5-93).

[53] One of the suggestions for changing retail customer payment practices is for the securities industry to use the ACH Network operated by the National Automated Clearing House Association. Use of the ACH Network would allow securities transactions to be paid by debit to a retail customer's bank account.

[54] *See, e.g.*, Letter from Dominick F. Antonelli, Chairman, PSA Municipal Securities Division Operations and Compliance Committee and Stephen W. Hopkins, Chairman, PSA Mortgage Securities Division Operations Committee to Jonathan G. Katz, Secretary, SEC (July 8, 1993).

[55] *See* letter from Bruce Vernon, President and Thomas Sargant, Vice President, Regional Municipal Operations Association, to Harold Johnson, Deputy General Counsel, MSRB (January 18, 1994).

[56] *See* "Automated Clearance and Settlement: Rules G-12 and G-15," *MSRB Reports*, Vol. II, No. 3 (September 1991) at 7. The Board noted that one reason for this development was the emergence of Book-Entry-Only ("BEO") securities, *i.e.*, securities that have been structured by the issuer so that certificates are not available to investors. These issues require retail customers to obtain safekeeping services from a dealer or bank with access to a depository. This, in effect, solves the problem noted above.

DTC reports that, in terms of par value, approximately 70% of new municipal securities issues are now being offered in BEO form. Significant progress has been made in recent years in persuading retail customers to accept BEO issues. Nevertheless, many retail customers do not wish to purchase BEO securities because of their desire for securities certificates. Accordingly, the Board believes that the decision whether a municipal securities issue should be in BEO form must be left to the issuer.

The Board believes that neither of the above described options provides an entirely satisfactory answer to the problem. Like the issue of payment mechanisms for retail customers, it appears that additional work will be needed on this issue by the securities industry and the Board will support these efforts.[57] The Board anticipates that these initiatives will concentrate on educational outreach to retail customers, educational efforts aimed at dealers and on other creative means to address T+3 problems (*e.g.*, electronic payment mechanisms for retail customers). The Board will participate in future activities of these groups, as appropriate, to ensure that the retail sector of the municipal securities market is addressed.

A. Confirmation Issues

In addition to the efforts described above, the Board also will seek to coordinate with the Commission any activities addressing retail customer issues in a T+3 environment. As noted in the Board's comment letter on Rule 15c6-1, a three-day settlement cycle will highlight certain issues concerning the function of the confirmation and the Board's customer confirmation rule, rule G-15(a).[58] Similar issues may arise with respect to the Commission's confirmation rule, Exchange Act Rule 10b-10.[59]

Since 1993, the Board has considered the content and timing of the written information that retail customers purchasing municipal securities should receive. One question being considered is whether the written disclosure provided to customers should continue to be effectively limited by the size of the standardized, nine-by-five inch confirmation form. Another question that is being reviewed is whether rule G-15(a) should require confirmations to be mailed (or sent by facsimile transmission, if requested by the customer) no later than T+1. The Board, as always, stands ready to cooperate with the Commission to ensure that an appropriate level of consistency is maintained between Board rule G-15(a) and Exchange Act Rule 10b-10.

V. RULE CHANGES TO CONVERT THE MUNICIPAL SECURITIES MARKET TO T+3 SETTLEMENT

As noted above, the Board has already adopted and proposed a number of rule changes and is working on other projects to help prepare the municipal securities market for T+3 settlement. To actually bring about T+3 settlement, certain additional rule changes will be needed.

A. Substance of Planned Rule Changes

Currently, rules G-12(b) and G-15(b) define "regular-way" settlement to be T+5 settlement. The Board plans to amend these rules to state that "regular way" settlement is defined as three business days after trade date. The Board's current intention is for these rules to make clear that the three-day settlement cycle does not apply to several types of transactions. For example, in when-issued transactions a dealer cannot settle with a customer or other dealer prior to the final settlement (or "closing") of the issue with the issuer. The closing date with an issuer is dependent upon many factors and cannot necessarily be scheduled within three days after trading begins in an issue. In addition, the Board believes that it may be necessary to provide some specific alternatives concerning secondary market transactions in securities that are not depository-eligible. Since it may be impossible to achieve a physical settlement within three days, the Board believes that the parties to a transaction in a non-depository-eligible issue should have the option of extending the settlement date by agreement if it is considered necessary by the parties.[60] Finally, the Board anticipates that the rules will make clear that, for secondary market transactions, T+3 settlement will be the norm and that, while the settlement date of secondary market trades may be extended on an ad-hoc basis by the agreement of the parties, no generalized exceptions may be implemented by a dealer other than those for non-depository eligible securities, as noted above.[61]

The Board intends to publish a notice in the summer of 1994 requesting comment on draft amendments to rules G-12(b) and G-15(b) on settlement date of regular way transactions and certain other conforming amendments.[62] In addition to requesting general comment on the draft amendments, the Board plans to request specific comment on any other exemptions that may be needed in the rules.

B. Timing for Conversion to T+3 Settlement

The Board understands and appreciates the operational difficulties that would be caused in the securities industry if the municipal

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[57] The SIA Clearance and Settlement Committee, is looking at these issues and has offered its assistance to the Board with respect to retail transactions in municipal securities. The Board also will have a representative on the PSA's Task Force on T+3 Settlement, which also will work on retail customer issues.

[58] Letter from Charles W. Fish, Chairman, MSRB, to Jonathan G. Katz, Secretary, SEC (May 17, 1993).

[59] The Board is aware that the Commission has sought comment on various issues relating to Rule 10b-10 and the conversion to T+3 settlement. Securities Exchange Act Release 34-33743 (March 9, 1994).

[60] The Board's rules do not preclude dealers from settling transactions in less than three business days by agreement. Currently, under Board rules G-12(b) and G-15(b), cash transactions settle on trade date.

[61] This is intended to track similar Commission views on Rule 15c6-1. *See Rule 15c6-1 Adopting Release* at 50, stating "[T]he proposed Rule allows a broker or dealer to agree that settlement will take place in more than three business days, when the agreement is expressed and reached at the time of the transaction." The Release also states that the "override provision was intended to apply only to unusual transactions .... It was not intended to permit broker-dealers to specify before execution of specific trades that a group of trades will settle in a timeframe other that T+3." *Id* at 51.

[62] For example, conforming amendments may be needed in Board rule G-15(d)(i), concerning the timing of actions needed with respect to settlement instructions given by customers in DVP/RVP transactions.

securities market does not convert to T+3 settlement at the same time as other securities.[63] Therefore, it is the Board's intention at this time to file the proposed amendments to rules G-12(b) and G-15(b) with the Commission in early March 1995, with a requested effective date of June 1, 1995, to coincide with the effective date of Rule 15c6-1.

Having stated its current intention, the Board wishes to emphasize that the ability of the municipal securities market to deal with T+3 settlement on parity with the corporate securities market depends, in part, upon the success of the efforts over the next year to improve the use of automated clearance and settlement systems for municipal securities. It is critical to the above stated timetable that these improvements on the institutional side of the municipal market be made before, and not after, the conversion date. Although the problems concerning retail transactions are difficult, the municipal securities market should be able to manage these issues on the same basis, and in the same time frames, as the corporate securities markets.

The Board will work with dealer organizations, registered clearing agencies, and other groups to ensure the success of T+3 efforts on the retail and institutional sides of the municipal securities market. The Board also will continue to keep the Commission informed on these efforts and the specific progress being made with respect to municipal securities.

[63] Fifty-four commentators responded to then proposed Rule 15c6-1 stating that having municipal securities settle in a different time frame than corporate securities will introduce significant processing inefficiencies and additional costs for industry members. *See Rule 15c6-1 Adopting Release* at 37.

Route to:

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

Requiring Underwriters to Apply for Depository Eligibility of New Issues: Rule G-34

Comments Requested

The Board is proposing for comment a draft amendment to rule G-34 that would require underwriters to apply for depository eligibility of new issue municipal securities.

The Board is proposing for comment a draft amendment to rule G-34 that would require underwriters to apply for depository eligibility of new issue municipal securities. The draft amendment would exempt issues that do not meet the criteria set by depositories for eligibility and new issues under $1 million in par value. The draft amendment would operate in concert with existing Board rules requiring book-entry settlement of depository-eligible issues. It is being proposed as one of several regulatory actions by the Board to facilitate the movement toward a shorter settlement cycle in the municipal securities market.

Background

In October 1993, the Securities and Exchange Commission approved Exchange Act Rule 15c6-1.[1] Rule 15c6-1 states that the current five-business-day settlement cycle in the United States will be compressed to three business days after trade date (T+3 settlement), beginning in June 1995. The intent of Rule 15c6-1 is to reduce various risks that are created in securities markets by transactions that have been executed but not settled. Although the Commission did not include municipal securities within the scope of the rule, the Commission requested that the Board develop a plan for converting the municipal securities market to T+3 settlement in order to maintain consistency with other U.S. securities markets.[2]

In response to the Commission's request, the Board has made a commitment to meeting the national goal of T+3 settlement. Over the past few years, the Board has been reviewing operational practices in the municipal securities market and has identified several areas where changes will be necessary. In March 1994, the Board provided the Commission with a report detailing these changes, along with the attendant regulatory actions that are planned to accomplish T+3 settlement in the municipal securities market.[3]

One area in which the Board believes action is needed concerns the use of physical securities certificates to settle inter-dealer and institutional customer transactions. Because these transactions are settled on a Delivery versus Payment or Receipt versus Payment (DVP/RVP) basis, it is critical that the delivery of securities be made in a timely manner on settlement date. However, the physical delivery of certificates is a relatively time-consuming and inefficient practice, as compared to book-entry delivery through a securities depository. A shortened settlement cycle will provide dealers, institutional customers and their clearing agents with considerably less time to deal with the processing requirements and inevitable problems that arise in connection with transportation, delivery and acceptance of physical securities certificates. In many situations, it may be difficult or impossible to deliver securities certificates within three days to accomplish a DVP/RVP settlement. Thus, the Board believes that the conversion to T+3 settlement would be facilitated if the practice of delivering physical securities certificates to settle inter-dealer and institutional customer transactions is discouraged in favor of book-entry settlement.

In 1993, the Board amended rules G-12(f)(ii) and G-15(d)(iii) to require essentially all inter-dealer and institutional customer transactions to be settled by book-entry when the securities involved in the transaction are listed as

Comments on the draft amendment should be submitted no later than May 31, 1994, and may be directed to Judith A. Somerville, Uniform Practice Specialist. Written comments will be available for public inspection after Board review.

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[1] Securities Exchange Act Release No. 34-33023 (October 6, 1993) [hereinafter cited as *Rule 15c6-1 Approval Order*].

[2] Letter from Arthur Levitt, Chairman, SEC, to David Clapp, Chairman, MSRB, (October 7, 1993) [reprinted in *MSRB Reports*, Vol. 14, No. 2 (March 1994), at 3].

[3] *Report of the Municipal Securities Rulemaking Board on T+3 Settlement for the Municipal Securities Market* (MSRB 1994) [reprinted in *MSRB Reports*, Vol. 14, No. 2 (March 1994) at 5].

eligible for deposit in a depository (*i.e.*, are depository-eligible).[4] While these rules have assisted the municipal securities industry in moving toward more universal use of book-entry settlement, the rules apply only to transactions in securities that are depository-eligible. Board rules do not currently require dealers to take any action to ensure that an issue of municipal securities is made depository-eligible.

Depository Eligibility of Municipal Securities

While the great majority of outstanding municipal securities currently are listed as depository-eligible, there are significant numbers of municipal securities that are not. For example, out of the estimated 1.2 million CUSIP numbers assigned to outstanding municipal securities, Depository Trust Company (DTC) indicated in January 1994 that it listed approximately 1.023 million as eligible. Of those issues not currently listed as depository-eligible at DTC or other depositories, some simply do not meet the eligibility criteria of the depository in question, while many others do meet the eligibility criteria of the depository and could easily become depository-eligible if an application were made by a depository participant.

In light of the planned conversion to T+3 settlement in 1995, the Board believes that it may be necessary to provide for mechanisms to ensure that new municipal issues are made depository-eligible to the greatest extent practicable.[5] The Board notes that, as other U.S. securities markets prepare for T+3 settlement, similar regulatory requirements are being considered for those markets. For example, one option being considered is for stock exchanges and the NASD to mandate depository eligibility for any issues that are listed on an exchange or the Nasdaq.[6]

Draft Amendment to Rule G-34

Rule G-34 currently states various actions that dealers must take to ensure that specific issues of municipal securities can be processed within automated clearance and book-entry settlement systems. Among its other requirements, rule G-34 states that the underwriter of a new issue must make an application to ensure the assignment of CUSIP numbers for the new issue, prior to the initial trade date for the issue.[7] The draft amendment to rule G-34 would add the requirement for the underwriter to make an application to establish the depository eligibility of the new issue no later than 10 business days prior to final settlement with the issuer (the closing date).[8] The draft amendment contains exceptions for: (i) issues that fail to meet the criteria for depository eligibility set by securities depositories; and (ii) issues under $1 million in par value.

As discussed below, it is contemplated that those issues not exempted under the draft amendment would become depository-eligible prior to the date of closing and the initial distribution of the issue to dealers and institutional customers. Accordingly, these initial transactions in the issue would be subject to rules G-12(f)(ii) and G-15(d)(iii) and would be required to be settled by book-entry delivery.[9] While most new issues of municipal securities already are distributed via a depository in this fashion, the draft amendment effectively would require this result for all issues within its scope.

Request for Comment

The Board is requesting comment on all aspects of the draft amendment and the need to ensure book-entry settlement of DVP/RVP transactions in a T+3 settlement environment. Specific comment is requested on the 10-day application provision and the exemptions provided in the draft amendment. These aspects of the draft amendment are discussed in more detail below.

Application to Depository 10 Days Prior to Closing Date

Under the draft amendment, the underwriter would have to make its application to a depository no later than 10 business days prior to the closing date. The requirement to make such application includes the requirement to provide information and other materials necessary for the depository to determine eligibility of the new issue. This period of advance notice to the depository is intended to provide adequate time for the depository to make an issue eligible and prepare for book-entry settlements in the issue prior to closing date.

The application for depository eligibility 10 days prior to closing is a practice currently requested by some depositories, even though the depositories can and do make new issues eligible on much shorter notice. While the draft amendment is intended to support the normal practice of underwriters making applications to a depository within the 10-day time frame, it is not intended to restrict the ability of underwriters to utilize the accelerated process offered by depositories when this is necessary due to circumstances beyond the underwriters' control.

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[4] *See* "Automated Comparison and Book-Entry Settlement of Inter-Dealer Transactions: Rule G-12," *MSRB Reports*, Vol. 13, No. 1 (January 1993) at 5; "Book-Entry Settlement Required for DVP/RVP Customer Transactions: Rule G-15(d)" *MSRB Reports*, Vol. 13, No. 4 (August 1993) at 17.

[5] The Board is aware that depositories have ongoing programs to make outstanding municipal issues depository-eligible, based on requests from participants and other factors. The Board nevertheless is concerned that thousands of new municipal issues continue to come to market each year without first being made eligible at a depository. For the period during which these issues remain non-eligible, they are exempt from the book-entry delivery requirements of rules G-12(f)(ii) and G-15(d)(iii), require physical settlements and thus create inefficiencies that would be detrimental in a T+3 environment.

[6] *See Rule 15c6-1 Approval Order* at 24.

[7] Rule G-34(a)(i)(A).

[8] As with the CUSIP number requirement, if there is an underwriting syndicate or similar account, the draft amendment places the duty of making application with the managing underwriter of the syndicate.

[9] The initial transactions in a new issue, of course, typically are executed on a "when, as and if issued" (when-issued) basis. When-issued transactions in municipal securities are not currently settled on a T+5 basis and it is not the Board's intention for when-issued transactions to be settled on a T+3 basis after the regular-way settlement cycle is converted to T+3. While there may be extra time between trade date and settlement date for when-issued transactions to be processed, the Board nevertheless believes that it is important to establish book-entry settlement as the routine practice for these transactions. The Board believes this is necessary to ensure the depository eligibility of new issues coming to market and to foster the deposit of new issue securities in a depository to facilitate book-entry settlement of subsequent transactions in the issue.

of Depositories

The draft amendment includes an exception for those issues that fail to meet the criteria for eligibility set by securities depositories.[10] The availability of this exemption for a specific issue would depend simply upon whether a securities depository would make the issue eligible if an appropriate application were made by the underwriter. As an example, some municipal issues continue to be issued with indenture provisions stating that partial calls will be made — as funds are available — in order of the certificate number appearing on each certificate (*e.g.*, certificate #1 is called first, followed by certificate #2 if funds are available, etc.). Such a provision may disqualify the issue from eligibility in a depository.

If the underwriter knows that a depository will not accept a new issue, the underwriter would not be required to make an application merely to be rejected by the depository. However, in cases in which an underwriter is unsure whether a new issue meets the eligibility criteria of a depository, the draft amendment, in effect, would require the underwriter to contact the depository in advance of issuance to establish the answer. Such discussions with the depository would need to take place in time for the underwriter to comply with the 10-day advance notice requirement of the draft amendment.

The Board notes that the exception in the draft amendment for new issues that do not meet a depository's eligibility criteria is necessary because the terms of a new issue ultimately are controlled by the issuer of the securities, who is not subject to Board rules. Unlike the depository eligibility initiatives being considered in other markets, the draft amendment does not incorporate a "listing requirement" which forces all new issues to be structured in a manner that meets the eligibility criteria of a depository. The Board, however, believes that the vast majority of municipal securities being issued today — perhaps 99% or more of the par value — do, in fact, meet depository eligibility criteria.[11] The Board requests specific comment on this point and would also appreciate suggestions on other actions that might be considered by the Board to help ensure depository eligibility of new issues.

The Board also notes that this exemption in the draft amendment would be available only if an issue fails to meet the eligibility criteria at *all* depositories accepting municipal securities. There currently are three depositories accepting municipal securities (DTC, Midwest Securities Trust Company and Philadelphia Depository Trust Company). While the Board believes that the eligibility criteria of these depositories are basically the same, there may be small differences. These differences might require an underwriter to apply at additional depositories for eligibility in cases in which the issue was rejected at the underwriter's depository of preference. The Board requests comment on whether these differences in eligibility criteria would cause inefficiencies or uncertainty under the draft amendment and, if so, what alternative formulation of the exemption would be preferable.

Exemption for Issues Under $1 Million in Par Value

The draft amendment would not require underwriters to apply for depository eligibility of new issues under $1 million in par value. The Public Securities Association has reported that, in 1992, new municipal issues under $1 million in par value accounted for only approximately one-half of one percent of the total par value issued that year.[12] However, these small issues are numerous, accounting for up to 19 percent of the number of new issues sold in 1992.[13]

Today, many new issues under $1 million in par value are efficiently distributed through a depository by book-entry and the Board wishes to encourage this trend as a means to facilitate T+3 settlement. The Board, however, is proposing the exemption from the requirements of the draft amendment because of concerns that have been expressed by some dealers that, for some small issues with a limited distribution, the costs of a book-entry distribution may be greater than the costs of a physical distribution of certificates.[14]

The Board is particularly interested in receiving comment on the proposed small issue exemption, including comment on the overall effect of the exemption on depository eligibility of new issues and whether the exemption is necessary in today's market. The Board is concerned that the continued practice of making DVP/RVP settlements using physical securities certificates does not appear to be a viable long-term option for the municipal securities market in a T+3 environment. Comment is requested on how this concern might be addressed with respect to the many small municipal issues that come to market each year and whether the Board should announce a "sunset" date for the exemption if the exemption is initially included in the draft amendment. The Board also requests comment on whether modifications should be made in the exemption with respect to any specific classes of municipal securities, such as notes, that may present different operational or financial considerations affecting book-entry delivery through securities depositories.

March 17, 1994

Text of Draft Amendment*

Rule G-34. CUSIP Numbers, [and] Dissemination of Initial Trade Date Information <u>and Depository Eligibility</u>

(a) - (c) No change.

(d) <u>Application for Depository Eligibility</u>

[10] This is similar to the provision in rule G-34 that requires applications to be made for CUSIP numbers. An underwriter is not required to apply for CUSIP numbers for an issue if the issue is not eligible for CUSIP number assignment.

[11] In negotiated underwritings, an underwriter can often work with a depository to help ensure that an issue with novel features is structured in a manner that makes it depository-eligible. The Board encourages underwriters to do this whenever possible and to inform issuers of the operational advantages that are obtained from depository eligibility.

[12] Letter from Andy Nybo, PSA, to Harold L. Johnson, MSRB (August 26, 1993).

[13] There were 2,434 issues under $1 million in par value issued that year, compared to a total of 12,888 issues that were brought to market. *Id.*

[14] *See, e.g.*, Letter from Regional Municipal Operations Association to Harold Johnson, MSRB (June 11, 1991).

* Underlining indicates additions; strikethrough indicates deletions.

(i) Except as otherwise provided in this section (d) and in section (e) of this rule, each broker, dealer or municipal securities dealer who acquires, whether as principal or agent, a new issue of municipal securities from the issuer of such securities for the purpose of distributing such new issue shall apply, in accordance with the rules and procedures of such depository, no later than 10 days prior to final settlement of the issue with the issuer, to make such new issue depository eligible.

(ii) This section (d) shall not apply to any issue that is less than $1 million in par value.

(e) Eligibility. The provisions of this rule shall not apply to an issue of municipal securities (or for the purposes of section (b) any part of an outstanding maturity of an issue) which does not meet the eligibility criteria for CUSIP number assignment. Section (d) of this rule shall not apply to an issue of municipal securities that fails to meet the criteria for depository eligibility at all depositories that accept municipal securities for deposit.

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Route to:

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

Enforcement Initiative: Rule G-12

Notice

Data will be provided to the enforcement agencies to identify those dealers who are in violation of Board rule G-12(f)(i) by not using the automated comparison system or by failing to submit all of their transactions in a timely and accurate manner on the night of trade date.

Effective February 1, 1994, Board rule G-12(f)(i) was amended to require dealers to submit all inter-dealer transactions to an automated comparison system operated by a registered clearing agency.[1] This rule was amended as part of the Board's overall plan to increase the use of automated clearance and settlement systems within the municipal securities industry and to prepare for the conversion to a shortened settlement cycle.

In light of the upcoming industry move to T+3 settlement, now scheduled for June 1, 1995, the Board is evaluating operational issues affecting the municipal securities market.[2] As part of this process, the Board has identified improved use of the automated comparison system as a necessary step in moving to T+3 settlement. The current rate of successful comparison in the initial comparison cycle is 75%. Since timely comparison is crucial even in today's T+5 settlement cycle, the initial comparison rate will need to be substantially improved prior to the conversion to T+3 settlement.

The Board has been working with National Securities Clearing Corporation (the central processor for comparison of inter-dealer transactions), and the agencies responsible for enforcement of Board rules to ensure that compliance with rule G-12(f)(i) is a major priority for the municipal securities industry over the next year. Data will be provided to the enforcement agencies to identify those dealers who are in violation of Board rule G-12(f)(i) by not using the automated comparison system or by failing to submit all of their transactions in a timely and accurate manner on the night of trade date.[3] Dealers not complying fully with rule G-12(f)(i) can expect to be contacted by their enforcement agency and may be subject to sanctions for violation of Board rules.

The Board urges all dealers to take this opportunity to review their procedures for submission of transactions for automated comparison and to ensure that all transactions are submitted in a timely and accurate manner.

March 8, 1994

Questions about this notice may be directed to Judith A. Somerville, Uniform Practice Specialist.

[1] Securities Exchange Act Release No. 34-33275 (December 2, 1993).

[2] For a more complete discussion of the Board's plan, see pages 3-14 of this issue of *MSRB Reports.*

[3] One of the statistics that will be provided to the enforcement agencies is the input percentage. This is defined as all transactions submitted for comparison divided by all transactions submitted for comparison plus stamped advisories.

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Notice of Approval

Route to:

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

Automated Clearance and Settlement: Rule G-15

Amendment Approved

Effective July 1, 1994, the amendment to rule G-15(d)(ii) will require that all DVP/RVP customer transactions that are eligible for confirmation/acknowledgement in a system operated by a registered clearing agency be processed in such a system.

The Securities and Exchange Commission has approved an amendment to Board rule G-15 (d)(ii) for effectiveness July 1, 1994.[1] The amendment to rule G-15(d)(ii) is the third and final phase of the Board's overall plan to complete the transition of the municipal securities market to automated techniques of clearance and settlement.

Currently, rule G-15(d)(ii) requires that Delivery Versus Payment or Receipt Versus Payment (DVP/RVP) customer transactions eligible for automated confirmation/acknowledgement systems be confirmed/acknowledged through such a system if each party to the transaction is a member of a registered clearing agency offering confirmation/acknowledgement services or uses a clearing agent for the transaction that is a member of such a clearing agency. The current rule does not require use of the automated confirmation/acknowledgement system if one or both of the parties are not members of the registered clearing agency performing automated confirmation/acknowledgement services. The current exemption in the rule was provided to allow dealers to make physical DVP/RVP settlements with customers that have not made arrangements to use the automated confirmation/acknowledgement systems. The exemption, adopted in 1984, was intended to exist only during the transition period to full use of automated clearance and settlement systems in the municipal securities market.

Effective July 1, 1994, the amendment to rule G-15(d)(ii) will require that all DVP/RVP customer transactions that are eligible for confirmation/acknowledgement in a system operated by a registered clearing agency be processed in such a system. Therefore, all dealers must ensure that their institutional customers receiving DVP/RVP privileges have access to a confirmation/acknowledgement system and use such system for confirmation/acknowledgement of DVP/RVP transactions.

January 24, 1994

Text of Amendment*

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

(a) through (c) No changes.

(d) *Delivery/Receipt vs. Payment Transactions.*

(i) No change.

~~(ii) No broker, dealer or municipal securities dealer who is, or whose clearing agent with respect to such transaction is, a participant in a clearing agency registered with the Securities and Exchange Commission shall effect a transaction in any municipal security to which a CUSIP number has been assigned on a delivery vs. payment or receipt vs. payment basis for the account of a customer who is, or whose agent with respect to such transaction is, a participant in such clearing agency (or in a clearing agency interfaced or otherwise linked with such clearing agency) unless the facilities of such clearing agency (or the facilities of a clearing agency interfaced or otherwise linked with such clearing agency, as necessary) are used for the confirmation and acknowledgment of such transaction.~~

(ii) Except as provided in this paragraph, no broker, dealer or municipal securities dealer shall effect a customer transaction for settlement on a delivery vs. payment or receipt vs. payment (DVP/RVP) basis unless the facilities of a clearing agency registered with the Securities and Exchange Commission (registered clearing agency) are used for automated confirmation and acknowledgment of the transaction. Each broker, dealer and municipal securities dealer executing a customer transaction on a DVP/RVP basis shall: (A) ensure that the customer has the capability, either directly or through its clearing agent, to

Questions about the amendment may be directed to Judith A. Somerville, Uniform Practice Specialist.

[1] *See* Securities and Exchange Act Release No. 34-33515 (January 24, 1994).

* Underlining indicates additions; strikethrough indicates deletions.

the capability, either directly or through its clearing agent, to acknowledge transactions in an automated confirmation/acknowledgment system operated by a registered clearing agency; and (B) submit or cause to be submitted to a registered clearing agency all information and instructions required by the registered clearing agency for the production of a confirmation that can be acknowledged by the customer or the customer's clearing agent; provided that a transaction that is not eligible for automated confirmation and acknowledgment through the facilities of a registered clearing agency shall not be subject to this paragraph (ii).

(iii) No change.

(e) No change.

Route to:

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

SEC Releases on Municipal Securities

On March 17, 1994, the Securities and Exchange Commission published three releases, reprinted below, concerning municipal securities disclosure. One release (File No. S7-4-94) provides interpretive guidance regarding the disclosure obligations of issuers and underwriters in the primary and secondary municipal securities markets. As a companion to the interpretative release, the Commission published proposed amendments to Rule 15c2-12 under the Securities Exchange Act of 1934 (File No. S7-5-94). Comments on these two releases must be received by the Commission prior to July 15, 1994. In the third release (File No. S7-6-94), the Commission published proposed amendments to its confirmation rule, Rule 10b-10, and proposed a new rule, Rule 15c2-13, to require confirmation disclosure of specified information in connection with a customer's securities transaction. The requirements of proposed Rule 15c2-13 deal with confirmations of municipal securities transactions. Comments on this release must be received by the Commission prior to June 15, 1994.

Comments on these releases should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 6-9, Washington, D.C. 20549. All comment letters should refer to the file numbers.

SECURITIES AND EXCHANGE COMMISSION
17 CFR Parts 211, 231 and 241
Release No. 33-7049; 34-33741; FR-42; FILE NO. S7-4-94
STATEMENT OF THE COMMISSION REGARDING DISCLOSURE OBLIGATIONS OF MUNICIPAL SECURITIES ISSUERS AND OTHERS
AGENCY: Securities and Exchange Commission.
ACTION: Interpretation; Solicitation of comments regarding possible future agency action.
SUMMARY: The Securities and Exchange Commission ("Commission") is publishing its views with respect to the disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. This interpretive guidance is intended to assist municipal securities issuers, brokers, dealers and municipal securities dealers in meeting their obligations under the antifraud provisions. The Commission is seeking comment on issues discussed in this release and possible future agency action.
DATES: Comments should be received on or before July 15, 1994.
ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6-9, Washington, D.C. 20549. Comment letters should refer to File No. S7-4-94. All comments received will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.
FOR FURTHER INFORMATION CONTACT: Ann D. Wallace ((202) 272-7282), Amy Meltzer Starr ((202) 272-3654), Vincent W. Mathis ((202) 272-3968), Division of Corporation Finance; Janet W. Russell-Hunter (with respect to Sections III.C.6. and V.) ((202) 504-2418), Division of Market Regulation, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.
SUPPLEMENTARY INFORMATION: In a companion release, the Commission is proposing rule amendments that prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer agrees to disseminate information to the secondary market and from recommending the purchase of a municipal security without reviewing such information.

I. EXECUTIVE SUMMARY

The recent high volume of municipal securities offerings, as well as the growing ownership of municipal securities by individual investors, has highlighted the need for improved disclosure practices in the municipal securities market, particularly in the secondary market. To encourage and expedite the ongoing efforts by market participants to improve disclosure practices, and to assist market participants in meeting their obligations under the antifraud provisions, the Commission is publishing its views with

respect to disclosures under the federal securities laws in the municipal market.

This interpretive release addresses the following:

(1) With respect to primary offering disclosure, despite the significant improvement in disclosure practices in recent years as a result of voluntary initiatives, increased attention needs to be directed at

- disclosure of potential conflicts of interest and material financial relationships among issuers, advisers and underwriters, including those arising from political contributions;
- disclosure regarding the terms and risks of securities being offered;
- disclosure of the issuer's or obligor's financial condition, results of operations, and cash flows. This information should include audited financial statements (or disclosure that the financial statements were not subject to audit) and an explanation of the accounting principles followed in the preparation of the financial statements, unless the statements were prepared in accordance with generally accepted accounting principles ("GAAP") or accompanied by a quantified explanation of any deviation from GAAP;
- disclosure of the issuer's plans regarding the provision of information to the secondary market; and
- timely delivery of preliminary official statements to underwriters and potential investors.

(2) The Commission is renewing its recommendation for legislation to repeal the exemption for corporate obligations underlying certain conduit securities from the registration and reporting requirements of the federal securities laws.

(3) Particularly because of their public nature, issuers in the municipal market routinely make public statements and issue reports that can affect the market for their securities; without a mechanism for providing ongoing disclosures to investors, these disclosures may cause the issuer to violate the antifraud provisions.

Basic mechanisms to address potential antifraud liability include:

- publication of financial information, including audited financial statements and other financial and operating information, on at least an annual basis;
- timely reporting of material events reflecting upon the creditworthiness of the issuer or the obligor and the terms of its securities, including material defaults, draws on reserves, adverse rating changes and receipt of an adverse tax opinion; and
- submission of such information to an information repository.

(4) Underwriters and municipal securities dealers are key players in maintaining the quality of disclosure in the municipal securities markets. The underwriter has a duty to review the issuer's disclosure documents before offering, selling or bidding for the securities and to have a reasonable basis for its belief as to the accuracy and completeness of the representations in the documents. Municipal dealers must have a reasonable basis for recommending the purchase of securities.

In a companion release,[1] the Commission is proposing for comment two related rule amendments, the first proposing to prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer makes a commitment to provide annual and event-related secondary market information to a designated repository; and the second proposing to prohibit a broker, dealer, or municipal securities dealer from recommending purchases of such issues in the secondary market if it does not review such information.

II. INTRODUCTION

A. The Municipal Securities Market

As detailed in the recent Staff Report on the Municipal Securities Market, the market for municipal securities is characterized by great diversity and high volume. Issuers, estimated to number approximately 50,000, include state governments, cities, towns, counties, and special subdivisions, such as special purpose districts and public authorities. It is estimated that there currently are 1.3 million municipal issues outstanding, representing approximately $1.2 trillion in securities.[2] In 1993, a record level of over $335 billion in municipal securities was sold, representing over 17,000 issues. This record financing was heavily influenced by refundings. Nevertheless, the level of long term new money financings, representing 49% of financings for the year, reflected continued growth. In 1993, there were $142 billion of new money long term financings, compared to $81 billion in 1988, a 75% increase.[3]

In recent years, the forms of securities used to meet the financing needs of these issuers have become increasingly diverse and complex. For example, conduit bonds, certificates of participation, and a variety of derivative products have joined traditional general obligation and revenue bonds as prevalent forms of municipal financing.[4]

In addition, there has been a change in the investor profile in the municipal securities market. By 1992, individual investors, including those holding through mutual funds, held 75% of the municipal debt outstanding, compared to 44% in 1983.[5]

Along with the changing investor profile, there has been a change in investor strategy. Traditionally, municipal bondholders have been buy and hold investors; however, this strategy has changed significantly with the growth and development of municipal

[1] Exchange Act Release No. 33742 (March 9, 1994) ("Companion Release").

[2] *See* Division of Market Regulation, Securities and Exchange Commission, *Staff Report on the Municipal Securities Market* ("Staff Report") (Sept. 1993) at 1.

[3] "A Decade of Municipal Finance," *The Bond Buyer* (Jan. 6, 1994) at 24.

[4] Staff Report at 1-2.

[5] *The Bond Buyer 1993 Yearbook* ("Bond Buyer 1993 Yearbook") at 61-63.

bond funds. Many of these funds actively trade their portfolio securities to take advantage of market conditions or to meet redemption needs.

B. SEC Oversight of the Municipal Securities Market

As the agency charged with administering the federal securities laws and overseeing this nation's securities markets, the Commission has an obligation to protect investors in the municipal markets from fraud, including misleading disclosures. As the New York City report stated nearly two decades ago:

> By virtue of the large dollar volume of municipal securities issued and outstanding each year, such securities are a major factor in the Nation's economy and the national securities markets. In light of the national scope of the municipal securities markets, there is an overriding federal interest in assuring that there is adequate disclosure of all material information by issuers of municipal securities.
>
> Although municipalities have certain unique attributes by virtue of their political nature, insofar as they are issuers of securities, they are subject to the proscription against false and misleading disclosures.[6]

The burgeoning volume and complexity of municipal securities offerings, as well as the retail nature of the market, heighten the need for market participants to seek to prevent fraud through the timely provision of material information concerning municipal issuers and securities.

While Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933,[7] and a mandated system of periodic reporting under the Securities Exchange Act of 1934,[8] it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of Section 17(a) of the Securities Act,[9] Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.[10] These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.[11] Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").[12]

C. Disclosure Practices and Calls for Enhanced Disclosure

In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by the demands of market participants and antifraud strictures. Spurred by the New York City fiscal crisis in 1975 and the Washington Public Power Supply System defaults,[13] participants in the municipal securities market have developed extensive guidance to improve the level and quality of disclosure in primary offerings of municipal securities, and to a more limited extent, continuing disclosure in the secondary market.

In 1989, the Commission adopted Rule 15c2-12 under the Exchange Act[14] to enhance the quality and timeliness of disclosure to investors in municipal securities.[15] The rule requires that underwriters (both bank and non-bank) of primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more obtain and distribute to their customers the issuers' official statements for the offerings. This mechanism provides underwriters an opportunity to review the issuer's disclosure documents before commencing sales to investors.[16]

There is a consensus that, over the last two decades, these market and regulatory efforts have improved significantly the quality of primary offering disclosure in the municipal securities markets.[17] Nonetheless, there continue to be concerns with the adequacy of municipal offering disclosure, particularly with respect to offerings of non-general obligation bonds and smaller issues.[18]

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[6] *Staff Report on Transactions in Securities of the City of New York* ("NY City Report") (Aug. 1977) Chapter III. at 1-2.

[7] *See* Section 3(a)(2) of the Securities Act (15 U.S.C. 77c(a)(2)).

[8] *See* Section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)).

[9] 15 U.S.C. 77q(a).

[10] 15 U.S.C. 78j(b); 17 CFR 240.10b-5.

[11] Sections 15(c)(1) and (2) of the Exchange Act (15 U.S.C. 78o(c)(1) and (2)).

[12] *See MSRB Manual* (CCH).

[13] *See* Securities and Exchange Commission, *Report of the Securities and Exchange Commission on Regulation of Municipal Securities* (1988); Securities and Exchange Commission, *Staff Report on the Investigation in the Matter of Transactions in the Washington Public Power Supply System Securities* (1988); Securities Act Release No. 6021, *Final Report in the Matter of Transactions in the Securities of the City of New York* (Feb. 5, 1979); NY City Report.

[14] 17 CFR 240.15c2-12; *see* Municipal Securities Disclosure, Securities Exchange Act Release No. 26100 (Sept. 28, 1988), 53 FR 37778 ("Proposing Release"); Municipal Securities Disclosure, Securities Exchange Act Release No. 26985 (July 10, 1989), 54 FR 28799 ("Adopting Release").

[15] Proposing Release, 53 FR at 37779-82; Staff Report at 25.

[16] Adopting Release, 54 FR at 28800.

[17] National Federation of Municipal Analysts, *Membership Survey Results Fall 1992 Disclosure Survey* ("NFMA Survey"); Public Securities Association, Municipal Securities Disclosure Task Force, *Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market* (June 1988) ("PSA Survey") (content and completeness of primary disclosure documents and sufficiency of financial information rated satisfactory to excellent by 94% and 93% of firms responding, respectively).

[18] *See* Letter to Chairman Levitt from Charles Mires, Allstate Insurance Company (Nov. 4, 1993, as updated Jan. 19, 1994) ("Allstate Letter") (primary market disclosure by conduits found inadequate in 43.8% of rated issues reviewed); NFMA Survey (local housing, special district, hospitals, long term healthcare and industrial development issues were found to provide the least disclosure); PSA Survey (small issue industrial development bonds received a low rating; issues of $10 million or less received a low rating).

Secondary market disclosure practices present greater concerns. Recent highly publicized defaults[19] and refundings,[20] as well as the tremendous level of issuances during the past two years, have heightened interest in municipal secondary market disclosure.[21] The PSA has testified that today "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."[22] Substantial issuer information, in the form of official statements, state-required reports, and other public documents, is available from the approximately 20% of municipal issuers that come to market frequently, accounting for 80% of the dollar volume of municipal securities issued.[23] However, the remaining issuers, representing 20% in dollar volume but 80% in number, which come to the market much less frequently, provide substantially less continuing information. Many of these issues are health care issues, housing issues, industrial development bonds, and other conduit financings,[24] financing sectors which have had the greatest incidence of defaults, both monetary and technical.[25] In addition, information often is unavailable for smaller issues of securities of general purpose units of government and the securities of special purpose districts and authorities.[26]

In response to a request by Commission Chairman Arthur Levitt for a recommended "market-participant sponsored solution" to the disclosure issues in the municipal securities market, on December 20, 1993, 12 groups and associations representing a broad range of market participants submitted to the Commission a Joint Statement on Improvements in Municipal Securities Market Disclosure (the "Joint Statement").[27] The Joint Statement sets forth "a framework for improving the availability of information in the marketplace" that calls for both continued market initiatives to improve issuer disclosure and "support from the SEC and the Municipal Securities Rulemaking Board (MSRB)."[28] Among other things, its participants recommend the adoption of a rule or interpretive guidance restricting underwriting of municipal issues unless continuing information covenants are provided by the issuer.

III. PRIMARY OFFERING DISCLOSURE

A. Application of the Antifraud Provisions

The antifraud provisions of the federal securities laws prohibit fraudulent or deceptive practices in the offer and sale of municipal securities.[29] Disclosure documents used by municipal issuers, such as official statements, are subject to the prohibition

[19] Examples include the defaults engendered by the failures of Mutual Benefit Life, Executive Life and Tucson Electric Power, and the bankruptcies arising out of the Colorado Special Districts. *See, e.g.*, Hinden, "Mutual Benefit Life's Collapse Shows Fragility of Bond Guarantees," *The Washington Post* (Jul. 22, 1991) at F 27; Levinson, "No Coverage Against Junk," *Newsweek* (Apr. 22, 1991) at 46; Stamas, "Rep. Dingell Asks SEC to Investigate Defaults by Special Assessment Districts in Colorado," *The Bond Buyer* (Jan. 25, 1991) at 1.

[20] *See* Gasparino, "Balancing Budgets Through Lease Deals May Pose Credit Risks, Rating Agency Warns," *The Bond Buyer* (Jan. 25, 1993) at 1; Herman, "Municipal-Bond Holders: Watch Out for 'Call' Shock," *The Wall Street Journal* (Aug. 29, 1992) at C1; Hume, "Dealer Threatens Suit Over Proposed Call for Escrowed Bonds," *The Bond Buyer* (Nov. 8, 1993) at 4; Hume, "Issuer in Louisiana May Run Afoul of Law if Escrowed Bonds Are Called Next Month," *The Bond Buyer* (Apr. 22, 1993) at 1; Hume, "Rise in Re-Refundings of Escrowed Bonds Likely to Gain Attention at Treasury, SEC," *The Bond Buyer* (May 12, 1992) at 1.

[21] *See generally*, Testimony of Jeffrey S. Green, General Counsel, Port Authority of New York and New Jersey on behalf of Government Finance Officers Association, before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("GFOA Testimony") at 7-9; Remarks by C. Richard Lehmann, President, Bond Investors Association Before the U.S. House of Representatives Subcommittee on Telecommunications and Finance Concerning the Municipal Securities Market, Oct. 7, 1993 ("Lehmann Testimony") at 4-5; Testimony of Andrew R. Kintzinger, President-Elect, National Association of Bond Lawyers, Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NABL Testimony") at 8-23; Testimony of Harvey Eckert, Chairman of the Blue Ribbon Committee on Secondary Market Disclosure on Behalf of the National Association of State Auditors, Comptrollers and Treasurers Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NASACT Testimony") at 3-6; Testimony Relating to the Municipal Securities Market given by the National Federation of Municipal Analysts, Katherine Bateman, Chairperson, to the Subcommittee on Telecommunications and Finance, Oct. 7, 1993 ("NFMA Testimony") at 1-7; Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee, Oct. 7, 1993 ("PSA Testimony") at 5-7; NASACT, *State and Local Government Securities Markets and Secondary Market Disclosure* (Oct. 1993) at 5; Stamas, "Issuers' Intentions on Secondary Market Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1; Standard & Poor's, "In Support of Secondary Market Disclosure," *CreditWeek Municipal* (Mar. 16, 1992).

[22] PSA Testimony at 5. *See also* Lehmann Testimony at 4; NASACT Testimony at 3; Nemes, "Investors' Service Steps in to Fill Void in Hospital Data Disclosure," *Modern Healthcare* (Feb. 3, 1992) at 46; Quint, "Credit Markets; Aiming for More Data About Municipal Bonds," *The New York Times* (June 28, 1993) at D5; Schifrin, "Hello, Sucker," *Forbes* (Feb. 1, 1993) at 40.

[23] NASACT, *Report of the Blue Ribbon Committee on Secondary Market Disclosure - Improving Secondary Market Disclosure* (Aug. 1993) ("NASACT Blue Ribbon Committee Report") at 1-2.

[24] *See id.* at 1. *See also* Allstate Letter.

[25] *See* Bond Buyer 1993 Yearbook at 3-5; *Municipal Bond Defaults - The 1980's; a Decade in Review* (J.J. Kenny Co., Inc. 1993)("Kenny Default Report"); Public Securities Association, *An Examination of Non-Rated Municipal Defaults 1986-1991* (Jan. 8, 1993) ("PSA Default Report"); Staff Report, Appendix B.

[26] *See* NASACT Blue Ribbon Committee Report at 1-2.

[27] *Joint Statement on Improvements in Municipal Securities Market Disclosure* ("Joint Statement") (Dec. 20, 1993) at 1. The Joint Statement was submitted by the American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Bond Lawyers, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, and Public Securities Association.

[28] *Id.*

[29] *See In re Washington Public Power Supply System Securities Litigation*, 623 F. Supp. 1466, 1478 (W.D. Wash. 1985). *See also Brown v. City of Covington*, 805 F. 2d 1266, 1270 (6th Cir. 1986).

against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. The adequacy of the disclosure provided in municipal security offering materials is tested against an objective standard: an omitted fact is material if there is a

> substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[30]

B. Voluntary Guidelines

In the primary offering of municipal securities, the extensive voluntary guidelines issued by the Government Finance Officers Association ("GFOA") have received widespread acceptance and, among a number of larger issuers, have been viewed as "in essence obligatory rules."[31] Other groups, including the National Federation of Municipal Analysts ("NFMA"), have published voluntary disclosure guidelines covering industry specific sectors, including among others, housing, student loans, transportation and healthcare.[32] In connection with the offering of municipal securities, the GFOA Guidelines call for:[33]

- An introduction to serve as the guide to the official statement;
- A description of the securities being offered, including complete information regarding the purposes of the offering, the plan of financing, the security and sources of repayment, and the priority of the securities, as well as structural characteristics, such as call provisions, tender options, original issue or deep discount, variable rates, and lease purchase agreements;
- Information regarding the nature and extent of any credit enhancement and financial and business information about the issuer of the enhancement;
- A description of the government issuer or enterprise, including information about the issuer's range or level of service, capacity and demographic factors and, in the case of revenue supported offerings, information on the enterprise's organization, management, revenue structure, results of operations and operating plan;
- With respect to obligations of private profit making and nonprofit conduit issuers, information regarding the business or other activity, including the enterprise's form of organization and management, rate-making or pricing policies, and historical operations and plan of operation;
- A description of the issuer's outstanding debt, including the authority to incur debt, limitations on debt, and the prospective debt burden and rate of its retirement;
- A description of the basic documentation, such as indentures, trust agreements and resolutions authorizing the issuance and establishing the rights of the parties;
- Financial information, including summary information regarding the issuer's or obligor's financial practices and results of operations, and financial statements, prepared in conformity with generally accepted accounting principles and audited in accordance with generally accepted auditing standards;
- A discussion of legal matters, such as pending judicial, administrative, or regulatory proceedings that may significantly affect the securities offered, legal opinions, and tax considerations; and
- A discussion of miscellaneous matters, including ratings and their description and meanings, underwriting arrangements, arrangements with financial advisors, interests of named experts, pending legislation, and the availability of additional information and documentation.

The guidelines prepared by the GFOA and the NFMA provide a generally comprehensive roadmap for disclosure in offering statements for municipal securities offerings. There are, however, areas that need further improvement in both the context of negotiated and competitively bid underwritings. In addition, implementation of these guidelines needs to be extended to the whole market. For example, while large repeat general obligation issuers usually have comprehensive disclosure documents, small issuers and conduit issuers, particularly in the healthcare, housing and industrial development areas, do not always provide the same quality of disclosure.[34]

C. Areas Where Improvement is Needed

1. Conflicts of Interest and Other Relationships or Practices

Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.[35] Recent revelations about practices used in the municipal

[30] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[31] Letter from Harlan E. Boyles, Treasurer of North Carolina to SEC Chairman Levitt, dated December 7, 1993. *See* Government Finance Officers Association, *Disclosure Guidelines for State and Local Government Securities* (Jan. 1991) ("GFOA Guidelines").

[32] *See* NFMA, *Disclosure Handbook for Municipal Securities 1992 Update* (Nov. 1992) ("NFMA Handbook"). *See also* Government Accounting Standards Board, *Codification of Government Accounting and Financial Reporting Standards* (2d ed. 1987); PSA, *Recommendations for a Consistent Presentation of Basic Bond Provisions in Official Statements* (Dec. 1989).

[33] GFOA Guidelines at xv-xix (summary).

[34] *See* NASACT Blue Ribbon Committee Report at 1-2; Staff Report at 26. Industry participants generally agreed in testimony before the House of Representatives Subcommittee on Telecommunications and Finance on October 7, 1993, that both the greatest disclosure problems and the greatest risk of default were with unrated hospital, housing, special district and industrial development revenue bonds.

[35] *See SEC v. Washington County Utility District*, 676 F.2d 218, 222 (6th Cir. 1982) ("Flagrant violations" of antifraud provisions arising from failure to disclose use of proceeds to purchase options on property held by issuer's manager and financial arrangements between the manager and the underwriter).

securities offering process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arms' length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, investors reasonably expect participants in municipal securities offerings to follow standards and procedures established by such participants, or other governing authorities, to safeguard the integrity of the offering process; accordingly, material deviations from those procedures warrant disclosure.

Existing rules and voluntary guidelines call for certain specific disclosures by offering participants. GFOA guidelines call for offering statement disclosure to investors of contingency fees to named experts, including counsel, and any other interest or connection those parties have with other transaction participants.[36] MSRB rules call for dealer disclosure to issuers and investors of any financial advisory relationship between an issuer and a broker, dealer, or municipal securities dealer, under certain circumstances.[37] MSRB rules also call for dealer disclosure to investors of, among other things, certain fees and expenses in negotiated transactions.[38]

Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case. If, for example, the issuer (or any person acting on its behalf) selects an underwriter, syndicate or selling group member, expert, counsel or other party who has a direct or indirect (for example, through a consultant) financial or business relationship or arrangement with persons connected with the offering process, that relationship or arrangement may be material.[39] Areas of particular concern are undisclosed payments to obtain underwriting assignments and undisclosed agreements or arrangements, including fee splitting, between financial advisers and underwriters.[40] If the adviser is hired to assist the issuer, such relationships, financial or otherwise, may divide loyalties. Similarly, affiliations between sellers of property to be used in a financed project and conduit borrowers raise questions regarding, among other things, the determination of fair market value of the property and self-dealing.

2. Terms and Risks of Securities

Evolution in the financial markets has led to increasingly complex and sophisticated derivative and other municipal products. While these new products offer investors a wide range of investment alternatives, in choosing among the alternatives, investors need a clear understanding of the terms and the particular risks arising from the nature of the products.[41]

In particular, investors need to be informed about the nature and effects of each significant term of the debt, including credit enhancements and risk modifiers, such as inverse floaters and detachable call rights. Investors in these securities should be aware of their exposure to interest rate volatility, under all possible scenarios. In addition, any legal risk concerning the issuer's authority to issue securities with unconventional features needs to be disclosed. The PSA recently has identified disclosure that should be provided in connection with the offer of financial instruments that include such features as auction and swap-based inverse floaters and embedded cap bonds.[42]

Credit enhancements are used with increasing frequency in the municipal market. According to published information, over 37% of the dollar volume of new long term issues carry some form of credit enhancement.[43] The existence of bond insurance or other credit enhancement creates the need for disclosure concerning the provider of the credit enhancement and the terms of the enhancement[44] to avoid misleading investors concerning the value of the enhancements provided and the party's ability to fund the enhancement. The GFOA recommends that appropriate financial information about the assets, revenues, reserves and results of operations of credit enhancers be provided in the official statement. In determining the extent of disclosure, consideration should

[36] Section XII.D. of the GFOA Guidelines.

[37] MSRB rule G-23.

[38] MSRB rule G-32. *See* Section 15B(c)(1) of the Exchange Act (15 U.S.C. 78o-4(c)(1) (requiring compliance with MSRB rules); MSRB rule G-17.

[39] Gasparino, "The Trouble with Consultants", *The Bond Buyer* (Nov. 16, 1993) at 1. In his testimony before the Subcommittee on Telecommunications and Finance, Andrew Kintzinger, on behalf of the National Association of Bond Lawyers ("NABL"), stated:

> [M]embers of the municipal finance bar should work with issuers to develop procurement procedures for state and local governments to ensure that all material financial arrangements between underwriters within the syndicate and between underwriters and financial advisors and possible conflicts of interest between issuers and members of the underwriting syndicate or other participants be accurately documented and disclosed or, if appropriate, prohibited.

NABL Testimony at 28. *See* Joint Statement at 2.

[40] Gasparino, "Several Issuers Start to Scrutinize Ties Between Advisers, Bankers," *The Bond Buyer* (Dec. 27, 1993) at 1. *See* Section XII.C. of the GFOA Guidelines; Rule G-23 of the MSRB.

[41] As the NABL Testimony indicates: "Derivatives are sophisticated securities products designed for sophisticated investors and should not be sold to retail investors generally and certainly not without comprehensive disclosure. If issuers choose to undertake the financial benefits of these sophisticated and complicated transactions, they can assume the financial costs of providing ...information." NABL Testimony at 22.

[42] PSA, *Recommendation on Dissemination of Product - Specific Terms For Municipal Derivative Products* (1993).

[43] PSA, *Municipal Market Developments* (Aug. 1993) at 5.

[44] *See* Revisions to Rules Regulating Money Market Funds, Securities Act Rel. No. 7038, 58 FR 68585, 68588 (footnote omitted) ("Money Market Fund Release"); Securities and Exchange Commission, *Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities* (Aug. 28, 1987) ("SEC Financial Guarantee Report") at 82; Adopting Release, 54 FR at 28812.

be given to the amount of the enhancement relative to the income and cash flows of the issuer or obligor, conditions precedent to application of the enhancement, duration of the enhancement, and other factors indicating a material relationship between the enhancement and the investor's anticipated return.

In a trend that has become increasingly common, municipal bond insurers are including in indentures provisions that appear to delegate to the bond insurer the ability to modify terms of the indenture, prior to default, without the consent of, or even prior notification to, bondholders.[45] There should be clear disclosure of any such provision that may have a material impact on the rights of bondholders or the obligations of the issuer, including the specific material rights of the bondholder that could be so altered.

3. Financial Information

a. Financial Accounting

Sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities.[46] The key to the reliability and relevancy of the information contained in the financial statements of a municipal issuer is the use of a comprehensive body of accounting principles consistently applied by the issuer.[47]

Although there continues to be some diversity in the financial reporting practices used in preparing financial statements of governmental issuers, practice in the municipal market is evolving rapidly to reliance on generally accepted accounting principles ("GAAP") as determined by the Government Accounting Standards Board ("GASB").[48] Only two years after GASB was founded in 1984, financial statements prepared in accordance with GAAP, as promulgated by GASB, were required by 75.2% of cities, 78.3% of counties and 69% of school districts responding to a research survey.[49] Forty-six states currently require, or are in the process of establishing a requirement, that state government financial statements be presented in accordance with GAAP.[50] In addition, local as well as state governments that receive significant amounts of federal aid must prepare financial statements in accordance with GAAP or provide information concerning variance from GAAP.[51]

The GFOA Guidelines call for financial statements that are either prepared in accordance with GAAP or accompanied by a quantified (if practicable) explanation of the differences.[52] To avoid misunderstanding, investors need to be informed of the basis for financial statement presentation. Accordingly, when a municipal issuer neither uses GAAP nor provides a quantified explanation of material deviations from GAAP, investors need a full explanation of the accounting principles followed.

b. Audits

Investors in the public securities markets have a reasonable expectation that annual financial statements contained in offering documents or periodic reports are subject to audit.[53] In the case of municipal issuers, these financial statement audits are typically conducted by either an independent certified public accountant or a state auditor. Although the frequency and timeliness of audits vary, every state requires some periodic audit verification of government financial statements.[54] A prudent investor needs to be able to evaluate the extent to which he or she can rely on the second look an auditor provides. Accordingly, the offering statement should state whether the financial statements it contains were audited in accordance with generally accepted auditing standards ("GAAS"), as established by the American Institute of Certified Public Accountants.

c. Other Financial and Operating Information

Financial information beyond that contained in the financial statements — provided in tabular and narrative format, footnotes, supplemental tables, schedules and discussions of operations and financial position — is essential to the fair presentation of an issuer's financial performance and position. As reflected in industry guidelines,[55] the type of information needed (*e.g.*, tax revenue base, budget, demographics, project revenues and operations) varies depending on the type of issuer, the type of security sold, and the sources for repayment of the bond obligations.

There are a number of areas in which greater care needs to be taken to provide investors with adequate information. In a pooled financing structure, such as that used by bond banks, in addition to providing financial information concerning the issuing authority or program in the aggregate, it may be necessary to provide information on participating obligors. This will depend on diversification and risk concentration factors, such as the significance of any single obligor to the overall financing.

Conduit bond issuers need to provide operational information concerning the activities of the private enterprise that will provide the cash flows to service the debt — for example, financial reporting, legal proceedings, changes in indebtedness, defaults and other

[45] *See* Allstate Letter.

[46] *See* NY City Report at Ch. II p. 92.

[47] *See* GFOA Guidelines at 50.

[48] The financial statements of corporate obligors backing conduit securities should follow GAAP for such entities, as established by the Financial Accounting Standards Board and other bodies.

[49] Ingram & Robbins, *Financial Reporting Practices of Local Governments*, Government Accounting Standards Board (1987) at 12 (The survey results were based on information received from 567 respondents to a survey questionnaire mailed to 1161 government units).

[50] *State Comptrollers: Technical Activities and Functions* (1992 Edition).

[51] Where state and local governments programs that are subject to the federal "Single Audit Act of 1984," P.L. 98-502 *et seq.* prepare financial statements on a basis other than GAAP, "the audit report should state the nature of the variances therefrom and follow professional guidance for reporting on financial statements which have not been prepared in accordance with GAAP." Office of Management and Budget, "Questions and Answers on the Single Audit Process of OMB Circular A-128, 'Single Audits of State and Local Governments,'" 52 FR at 43716 (Nov. 13, 1987), question 35.

[52] GFOA Guidelines at 45.

[53] *See* Gauthier, *An Elected Official's Guide to Auditing* (1992) at vii and xi.

[54] State Comptrollers: Technical Activities and Functions; NASACT, *Municipal Task Force Report* (1990) ("NASACT 1990 Task Force Report") at 12.

[55] *See generally*, GFOA Guidelines; NFMA Handbook. *See also infra* n. 84.

significant developments relating to the underlying corporate obligor. Where the issuing authority in a conduit financing has no remaining obligation for the repayment of the indebtedness, in providing financial information about the issuing entity (as compared to the obligor on the bonds), care must be taken to avoid misleading investors regarding the sources of repayment.[56]

Municipal issuers also must consider disclosure issues arising from their activities as end users of derivative products. For example, the use of non-exchange traded derivatives to alter interest rate risk exposes the issuer to counterparty credit risk. Disclosure documents need to discuss the market risks to which issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies. The NFMA has published sector specific secondary market disclosure guidelines calling for a discussion of the issuer's use of derivative products, especially interest rate swaps.[57]

Moreover, in addition to financial and operating data, the official statement may need to include a narrative explanation to avoid misunderstanding and assist the reader in understanding the financial presentation. A numerical presentation alone may not be sufficient to permit an investor to judge financial and operating condition of the issuer or obligor.[58] For example, it may be necessary to explain the presentation of budget information and the relationship of the budget figures to the financial statements.

In addition, issuers must assess whether the future impact of currently known facts mandate disclosure. The GFOA Guidelines call for a description of known facts that would significantly affect the financial information presented or future financial operation of the issuer, as well as a discussion of its projected operations.[59] For example, in a hospital financing, a steadily declining population in the surrounding community that, in the future, would not support the size of facility to be built would be important to investors. Disclosure of such currently known conditions and their future impact is critical to informed decisionmaking.

d. Timeliness of Financial Statements

The timeliness of financial information is a major factor in its usefulness. To avoid providing investors with a stale, and therefore potentially misleading, picture of financial condition and results of operations, issuers and obligors need to release their annual financial statements as soon as practical. After extensive discussion with market participants, it appears that, for the most part, audited financial statements of municipal issuers for the most recently completed fiscal year are available within six months after fiscal year end. The six month time period is consistent with the recommendations of NASACT's Blue Ribbon Committee Report.[60] Unaudited financial statements should be provided when available prior to the completion of the audit.

4. Availability of Continuing Information

An investor's ability to monitor future developments affecting the issuer, as well as the likely liquidity of a security, are important to an investor's evaluation of an offering. The official statement should state clearly whether ongoing disclosure concerning the issuer or obligor will be provided, including the type, timing, and method of providing such information.[61] In deciding whether to purchase the securities or to continue to hold them, investors need to know whether the issuer has committed to provide information on an ongoing basis.[62] The absence of such a commitment can adversely affect the secondary market for the securities and increases the risks of the investment.

As discussed above, the Joint Statement recommends that the Commission adopt a rule prohibiting a municipal securities dealer from underwriting securities absent a commitment to provide ongoing information. In the Companion Release, the Commission is proposing such a rule for comment. In order to fully inform investors, an issuer needs to include in the official statement a description of the scope of its continuing disclosure commitment, the type of information that would be provided, the repositories to which the information would be sent, when annual and other periodic information would be available, and the consequences of the issuer's failure to abide by the requirements of the covenant.

5. Clarity and Conciseness

Like other disclosure documents, official statements need to be clear and concise to avoid misleading investors through confusion and obfuscation. The expanded level of disclosure in official statements and increased sophistication of municipal securities instruments have, in many cases, resulted in longer and more complex disclosure documents, with the corresponding danger of overly detailed, legalistic, and possibly obtuse disclosure.[63]

The location, emphasis, and context of the disclosure can affect the ability of a reasonable investor to understand the

[56] *See* Letter of John Murphy, Executive Director of Association of Local Housing Finance Agencies to Chairman Levitt (Dec. 20, 1993).

[57] NFMA Handbook.

[58] *See* Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835 (May 24, 1989), 54 FR 22427; Securities Act Release No. 6711 (April 24, 1987), 52 FR 13715.

[59] GFOA Guidelines at 55.

[60] *See* NASACT Blue Ribbon Committee Report at 17. While due dates for audited financial statements of government units differ, a significant majority of states currently require audited financial statements for government units to be filed within six months after the fiscal year end. NASACT 1990 Task Force Report at 12-22.

[61] *See* Fall 1992 NFMA Survey. *See also* American Bankers Association, Corporate Trust Committee, *Four Point Public 1991 Disclosure Guidelines for Corporate Trustees* ("ABA 1991 Guidelines") at 2; Stamas, "Issuers' Intentions on Secondary Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1.

[62] *See* MSRB, *Report of the Municipal Securities Rulemaking Board on Regulation of the Municipal Securities Market* (Sept. 1993) at 6-7 (Board announced plan that would include requiring underwriters to recommend to issuers that they provide continuing disclosure to the market and requiring municipal securities dealers to disclose to their customers the negative impact that the lack of secondary market information may have on the value and liquidity of the securities and whether the issuer has agreed to voluntarily provide such disclosures).

[63] *See* GFOA Testimony at 6. *See also* Allstate Letter.

relationship between, and cumulative effect of, the disclosure.[64] As the U.S. Court of Appeals for the Second Circuit has stated:

> [D]isclosures in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither oversubtle nor overplayed, its meaning accurate, yet accessible.[65]

Appropriate disclosure "is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead" investors.[66] As the Commission has indicated in other contexts, legalistic, overly complex presentations and inattention to understandability can render the disclosure incomprehensible and consequently misleading.[67]

6. Delivery of Official Statements

One of the concerns leading to the adoption of Rule 15c2-12 was that underwriters were not receiving official statements within time periods that would allow them to examine the accuracy of the disclosure.[68] The Commission noted in proposing the rule that

> a thorough, professional review by underwriters of municipal offering documents could encourage appropriate disclosure of foreseeable risks and accurate descriptions of complex put and call features, as well as novel financing structures now employed in many municipal offerings. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Yet, underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis.[69]

To address this concern, the rule requires any underwriter, including lead underwriters, syndicate members, and selling group members that receive in excess of the usual seller's commission, to obtain and review an official statement that is deemed final as of its date by the issuer, except for the omission of certain information, before bidding for, purchasing, offering, or selling municipal securities in a primary offering.

Since the adoption of Rule 15c2-12, however, there have been continued problems with the timeliness of receipt by underwriters of the "near final" official statement required by the Rule.[70] In addition to compromising the ability of an underwriter to make a reasonable investigation of the issuer, this problem also may limit the ability of potential customers to make informed investment decisions. In a recent NFMA survey, 59% of those responding rated the delivery of preliminary official statements in competitive sales as either not very good or poor, and 50% rated the delivery of preliminary official statements in negotiated sales as either not very good or poor.[71]

One cause of delay has been confusion as to the point at which the underwriter must have obtained and reviewed the near final official statement in a negotiated offering. The term "offer" traditionally has been defined broadly under the federal securities laws and, for purposes of Rule 15c2-12, encompasses the distribution of a preliminary official statement by the underwriter, as well as oral solicitations of indications of interest. Thus, prior to the time that the underwriter distributes the preliminary official statement to potential investors, or otherwise begins orally soliciting investors, the rule requires it to have obtained and reviewed a near final official statement. If no offers are made, the underwriter is required to obtain and review a near final official statement by the earlier of the time the underwriter agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds to investors.[72]

The Commission has acknowledged that the rule would require greater planning and discipline by some issuers.[73] The Commission anticipated that, in order to allow underwriters to meet their obligation to have a reasonable basis for recommending any municipal securities, issuers would have to begin drafting disclosure documents earlier, and perhaps with greater care than in the past.[74] This result enables underwriters to receive, and if necessary influence the content of, the final official statement before

[64] *Isquith v. Middle South Utilities*, 847 F.2d 186, 201 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Kas v. Financial General Bankshares, Inc., et al.*, 796 F.2d 508, 516 (D.C. Cir. 1986); *Kennedy v. Tallant*, 710 F.2d 711, 720 (11th Cir. 1983).

[65] *Isquith*, 847 F.2d at 202.

[66] *McMahan & Company, et. al. v. Wherehouse Entertainment, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990).

[67] *See, e.g.*, Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests, Securities Act Release No. 6900 (June 25, 1991) 56 FR 28979, 28980 ("Limited Partnership Release").

[68] Proposing Release, 53 FR at 37781.

[69] Proposing Release, 53 FR at 37782.

[70] As a practical matter, near final official statements distributed to underwriters to satisfy Rule 15c2-12(b)(1) are often the same document as the preliminary official statement distributed to potential customers pursuant to Rule 15c2-12(b)(2). *See* Mudge Rose Guthrie Alexander & Ferndon (April 4, 1990) ("Mudge Rose") (rejecting the argument that in a negotiated offering, the identification of a credit enhancer and related information about the credit enhancer may be omitted on the assumption that the information depends on pricing). *See also* Fippinger & Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 47 Business Lawyer 127, 140 (Nov. 1991). In addition, underwriters are required to deliver to potential customers, upon request, copies of the final official statement for a specified time period. Rule 15c2-12(b)(4).

[71] NFMA Survey. *See also* Letter from Jeffrey M. Baker, Chairperson, NFMA Industry Practices and Procedures Committee and Richard A. Ciccarone, Past Chairperson, NFMA Industry Practices and Procedures Committee to Arthur Levitt, Chairman, Securities and Exchange Commission, Christopher A. Taylor, Executive Director, MSRB and Joseph R. Hardiman, President and Chief Executive Officer, National Association of Securities Dealers, Inc. (Oct. 19, 1993) (regarding the timeliness of receipt of near final and preliminary official statements).

[72] *See* Mudge Rose.

[73] Adopting Release, 54 FR at 28804. The Commission also noted that the requirements of Rule 15c2-12(b)(1) could be met through the use of multiple documents. For example, a frequent issuer might be able to supply a recent official statement, together with supplementary information containing the terms of the current offering, as well as any material changes from the previous offering materials.

[74] Proposing Release, 53 FR at 37790.

committing themselves to an offering.[75] Moreover, placing an obligation on the issuer to prepare the official statement at an earlier stage is appropriate, because it is the issuer's obligation to ensure that there is timely dissemination of disclosure documents in connection with the offer and sale of the issuer's securities.[76]

D. Conduit Financings

When financing involves a third party as the source of repayment, investors need information on that underlying borrower. The GFOA Guidelines call for description of conduit obligors, which are defined by the GFOA Guidelines to include both private profit-making and nonprofit entities.[77] The suggested information includes the nature and development of the business or other activity to be undertaken by the conduit obligor (including its form of organization and management), location of principal facilities and service area, ratemaking or pricing policies and historical operations and plan of operations.

To address disclosure issues involving conduit financings in a comprehensive fashion, however, legislation addressing the exempt status of conduit securities under the federal securities laws is necessary. Bonds used to finance a project to be used in the trade or business of a private corporation are, from an investment standpoint, equivalent to corporate debt securities issued directly by the underlying corporate obligor.[78] Payments on these types of conduit securities are derived solely from revenues received by the governmental entity under the terms of a contractual agreement, typically a lease or a note, from a private enterprise, rather than from the general credit and taxing power of the governmental issuer. The tax-exempt status of interest payments does not alter the fundamental analysis that these are private obligations, in which the investor looks, and can look, only to a private entity for repayment.

The private nature of many conduit enterprises distinguishes them from traditional municipal financings. The incidence of bond default appears to be inversely related to the degree a financed project represents an essential public service.[79] A study conducted by the PSA on non-rated issues that defaulted found that 75% were issued by local authorities in the areas of health care and industrial related sectors such as energy, chemical, pollution control and industrial development.[80]

Given the essentially private nature of non-governmental industrial development financings, investors need the same disclosure regarding the underlying non-municipal corporate obligor as they would receive regarding any corporate obligor, and the same regulatory and liability scheme should apply. Accordingly, the Commission has consistently supported legislative proposals to amend Section 3(a)(2) of the Securities Act[81] and Section 3(a)(29)[82] of the Exchange Act to remove the registration exemption for the corporate credit underlying municipal conduit securities involving non-governmental industrial development (private activity) financings.[83] The Commission today renews that legislative recommendation.

Pending amendment to the securities laws to eliminate the registration exemption, the disclosure provided by such non-governmental conduit borrowers should be substantially the same as if such conduit borrower were subject to the information requirements of the federal securities laws applicable to the particular conduit borrower. For example, financial statements prepared in accordance with generally accepted accounting principles prescribed by the Financial Accounting Standards Board should be provided.

IV. DISCLOSURE IN THE SECONDARY MARKET FOR MUNICIPAL SECURITIES

While significant progress has been made in primary market disclosure practices in recent years, the same development has not taken place with respect to secondary market disclosure. The GFOA issued separate secondary market disclosure guidelines in 1979, but they have not yet achieved the broad acceptance accorded its primary offering guidance. In the last five years, the NFMA, the National Council of State Housing Agencies, and the Association of Local Housing Authorities have published sector specific guidelines for secondary market disclosure; the National Advisory Council of the National Association of State Auditors,

[75] *Id.*

[76] *See* Adopting Release, 54 FR at 28811 N. 84 (official statement is issuer's document).

[77] GFOA Guidelines at 26. In a recent policy statement, the GFOA referred to "conduit bonds" as "municipal securities issued by a state or local government for the benefit of a private corporation or other entity that is ultimately obligated to pay such bonds * * *." GFOA, Committee on Governmental Debt and Fiscal Policy, *Improvements in Municipal Securities' Market Disclosure* (Feb. 1, 1994) ("GFOA Disclosure Policy Statement").

[78] *See* Money Market Fund Release, 58 FR at 68588 (proposal to subject tax exempt money market fund investments in conduit securities to restrictions similar to those applicable to securities of comparable obligors offered to taxable funds).

[79] Kenny Default Report at 2.

[80] PSA Default Report at 12.

[81] 15 U.S.C. 77c(a)(2).

[82] 15 U.S.C. 78c(a)(29).

[83] *See* Remarks of David S. Ruder, Chairman, SEC, "Disclosure in the Municipal Securities Markets," Before the Public Securities Association (Oct. 23, 1987) at 17-18; Letter from John S.R. Shad, Chairman, SEC to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985); 124 Cong. Rec. 21,639 (1978) (letter from SEC Chairman Harold M. Williams to Senator Harrison A. Williams). There were two bills introduced, one in 1975 and one in 1978, that would have repealed the exemption from the registration requirements of the Securities Act of 1933. The 1978 bill would have subjected certain industrial development bonds to the registration requirements of the Securities Act of 1933, the filing and qualification provisions of the Trust Indenture Act and the periodic reporting requirements of the Securities Exchange Act of 1934. Neither bill was enacted. *See also* "Municipal Securities Full Disclosure Act of 1976," S. 2969, 94th Cong., 2d. Sess. (Feb. 17, 1976). Governmental industrial development financings, which would have retained their exempt status under prior proposals, include those financings in which the bonds are repaid from the general revenues of the governmental unit or the project or facility is a public facility (or part of a public facility) and owned and operated by or on behalf of the governmental unit. The prior proposals to register conduit financings would not have affected the separate exemption for securities issued by non-profit charitable organizations in Section 3(a)(4) of the Securities Act (15 U.S.C. 77c(a)(4)).

Comptrollers and Treasurers ("NASACT") is in the process of preparing such guidelines for adoption by the states.[84] The GFOA's longstanding Certificate of Achievement program recognizes issuers that have prepared comprehensive annual financial reports meeting its guidelines. The NFMA's Award of Recognition Program likewise recognizes issuers that have committed to provide continuous disclosure.

A. Application of Antifraud Provisions

Participants in the municipal securities market do not dispute the need for ongoing disclosure following an offering of securities, but municipal issuers reportedly resist developing a routine of ongoing disclosure to the investing market because of concerns about the costs of generating and disseminating that information and about potential liability relating to such disclosure. These issuers and obligors are at times advised by their professional advisors that there is no duty under the federal securities laws to make disclosure following the completion of the distribution.[85] At least some municipal issuers thus appear to believe that silence shields them from liability for what may later be found to be false or misleading information. As a practical matter, however, municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering. In light of the public nature of these issuers and their accountability and governmental functions, a variety of information about issuers of municipal securities is collected by state and local governmental bodies, and routinely made publicly available.[87] Municipal officials also make frequent public statements and issue press releases concerning the entity's fiscal affairs.

A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.[87] The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions.[88] Those statements are a principal source of significant, current, information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market. As the U.S. Court of Appeals for the Second Circuit has said: "The securities markets are highly sensitive to press releases and to information contained in all sorts of publicly released . . . documents, and the investor is foolish who would ignore such releases."[89] Since investors obtain information concerning the fiscal health of a municipal issuer from its public statements concerning financial and other matters, "[t]he nature of these statements and the assumptions upon which they are based must be carefully and accurately communicated to the public, so that potential investors may be fully informed of all material facts relevant to their investment decision."[90]

The current process by which municipal issuers and their officials release information to market participants does not address the risk of misleading investors, because there is no mechanism for disseminating information about the municipal issuer to the market as a whole. To the contrary, in the municipal market, information released publicly frequently is disseminated only to a narrow segment of the marketplace. For example, market participants who request current information from indenture trustees are often turned away on the grounds that they are not current holders of the securities.[91] As a result, investors purchasing municipal securities in the secondary market risk doing so on the basis of incomplete and outdated information.

Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but

[84] *See* Association of Local Housing Finance Agencies, *Guidelines for Information Disclosure to the Secondary Market* (1992) ("Local Housing Guidelines"); National Council of State Housing Agencies, *Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds* (1989) and *Multi-family Disclosure Format* (1991) collectively ("State Housing Guidelines"); NFMA Handbook. *See also* Healthcare Financial Management Association, *Statement of Principles of Public Disclosure of Financial and Operating Information by Healthcare Providers* (Exposure Draft dated Aug. 1, 1993) ("Healthcare Disclosure Principles").

[85] *See* Stamas, "Issuers' Intentions on Secondary Market Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1; Stamas, "Why the Issue of Secondary-Market Disclosure Remains on the Back Burner: It Can Be Risky," *The Bond Buyer* (Sept. 20, 1991) at 1; Stamas, "Analysts Warn Issuers About Some Lawyers' Disclosure Advice," *The Bond Buyer* (Jan. 15, 1991) at 1.

[86] *See* NASACT Blue Ribbon Committee Report at 2, 24; NASACT 1990 Task Force Report at 21.

[87] *See* Public Statements by Corporate Representatives, Securities Act Release No. 6504, (Jan. 20, 1984) 49 FR 2468, 2469; *In re Ames Dept. Stores Inc. Stock Litigation*, 991 F.2d 953, 965-67 (2d Cir. 1993) (with respect to corporate information).

[88] *See* Fippinger, *The Securities Law of Public Finance* (2d ed. 1993) at 291 ("[P]ress releases, conversations with analysts, information meetings, official comments on budget negotiations, and even angry reactions by public officials to rating agency downgrades" are subject to antifraud provisions).

[89] *Ames*, 991 F.2d at 963 (corporate information).

[90] NY City Report at Ch. III at 2. The report found that public statements by City officials were misleading, since they were characterized by unwarranted reassurances as to the soundness and attractiveness of the City's securities, including statements that the City's budget problems, no matter how serious, had nothing to do with the City's ability to pay its debts. *Id.* at 110-111.

Municipal issuers should also be sensitive to whether their official statements contain forward-looking statements, such as projections of revenues, that remain alive in the market and may require updating in light of subsequent events. Guides for Disclosure of Projections of Future Economic Performance, Exchange Act Rel. No. 5992 (Nov. 7, 1978), 43 FR 53246. To the extent that the official statement in many cases remains the principal (or perhaps even the sole) source of information concerning an outstanding security, the potential for an obligation to update is of particular importance.

[91] Under notice provisions of indentures, the issuer and trustee generally are required to provide notice to existing bondholders of events of default and other significant matters, such as a draw on reserves, a failure to renew a letter of credit, or a substitution of collateral. ABA 1991 Guidelines at 10. Indeed, trustees often deny requests by market participants for information out of concern for liability arising from exceeding the authority set forth in the indenture. Fippinger at 325. This situation led the American Bankers Association Corporate Trust Committee, in cooperation with the National Association of Bond Lawyers, to develop agreed upon guidelines for indenture provisions permitting the trustee to provide public notice of specified events. *See* ABA 1991 Guidelines.

nevertheless may reasonably be expected to reach the securities markets. As market participants have urged,[92] in order to minimize the risk of misleading investors, municipal issuers should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security.[93]

B. Secondary Market Disclosure

There is general recognition of the need for disseminating comprehensive information on an annual basis and, on a more timely basis, information about material events that reflect on the credit quality of the security.[94]

1. Annual Information

Investors need updated comprehensive information sufficient to enable them to evaluate the financial condition, results of operations and cash flows of the issuer or underlying borrower. Although the issuance of comprehensive annual information has not yet become prevailing practice, it is recommended by industry disclosure guidelines, including those published by the GFOA in connection with its Comprehensive Annual Financial Reports ("CAFRs") award program, NFMA, and the other industry specific guidelines,[95] and is an effective means of providing the market updated information about the issuer and the issue. The GFOA Guidelines for Continuing Disclosure call for, either in an official statement or comprehensive annual report, a description of:

- the issuer and its structure, management, assets and operations;
- the issuer's debt structure (including changes in indebtedness);
- the issuer's finances (including financial condition and results of operations and financial practices of the issuer or the enterprise);
- legal matters affecting the issuer, including litigation and legislation,
- ratings, and
- interests of certain persons.

The GFOA Guidelines also specify additional information to be provided by conduit borrowers. The eligibility criteria for a Certificate of Achievement from GFOA include audited financial statements prepared in accordance with GAAP, reported upon by an independent public auditor. The guidelines for CAFRs include both a financial section and a statistical section.[96]

For frequent issuers, current information can be disseminated in official statements for new offerings, and thus is readily available without the preparation of a separate annual financial report. Regardless of the form of document relied upon to provide the marketplace with information concerning the financial condition of the issuer or obligor, to minimize risk of misleading investors, issuers or obligors should provide, as discussed above with respect to primary offerings:

- financial statements that are audited in accordance with GAAS (or disclosure of the absence of such an audit) and that are either prepared in accordance with GAAP, or accompanied by a quantified explanation of material deviations from GAAP or a full explanation of the accounting principles used;
- other pertinent financial and operating information (depending on the type of issuer and security sold), as well as the sources for repayment—of course, a variety of information may be appropriate for an issuer with a range of outstanding securities with differing characteristics, from general obligation to revenue and conduit bonds; and
- a narrative discussion that analyzes the issuer's or obligor's financial condition, and results of operations, as well as facts likely to have a material impact on the issuer or obligor.

Clarity and conciseness are equally relevant concerns with respect to ongoing disclosures, as with official statements.

As discussed above with respect to offering statements, as a general matter, the annual financial information may reasonably be expected to be made available within six months of the issuer's fiscal year end.[97] For some conduit entities, annual information may not be sufficient and investors may need more frequent periodic financial information. Under guidelines developed by the National Council of State Housing Agencies, for example, current information on loan portfolio status is compiled and disseminated to information repositories on a quarterly basis.[98] Similar ongoing disclosure on a periodic basis appears appropriate for analogous conduit municipal financings such as structured student loan programs, housing and healthcare financings.

2. Event Disclosure

In addition to periodic information, to assure that participants in the secondary market base their investment decisions on

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[92] *See* GFOA Guidelines at 91-97; Joint Statement.

[93] National Association of Bond Lawyers and Section of Urban, State and Local Government Law, American Bar Association, *Disclosure Roles of Counsel in State and Local Government Securities Offerings* at 135 (forthcoming 1994) (Pre-publication Draft) ("ABA Disclosure Roles") (noting that many municipal issuers have concluded that post-issuance disclosure in accordance with GFOA guidelines can be more efficient and expose them to less potential liability than ad hoc disclosures).

[94] *See* GFOA Testimony; Mires, "An Investor's Framework for Examining Disclosure Issues and Possible Solutions," *The Bond Buyer* (Feb. 7, 1994) at 24; NASACT Blue Ribbon Committee Report at 7. *See also* PSA Testimony at 6, supporting annual financial statement filing requirements and submission of information regarding any material fact for issuers who borrow $1 million or more annually.

[95] *See* ABA Disclosure Roles at 134-136; ABA 1991 Guidelines; Association of Local Housing Guidelines; Healthcare Disclosure Principles. The Disclosure Task Force of the National Council of State Housing Agencies is developing standards for the issuance of audited financial and annual reports.

[96] *See* GFOA Certificate of Achievement for Excellence in Financial Reporting Program; GFOA Guidelines at 64.

[97] *See* Section III.C.3.d. above.

[98] State Housing Guidelines.

current information, commentators have called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities. There is a general consensus among participants in the municipal securities market that investors need information about the following events, among others, where material:[99]

a. Principal and interest payment delinquencies
b. Nonpayment related defaults
c. Unscheduled draws on reserves
d. Unscheduled draws on credit enhancements
e. Substitution of credit or liquidity providers, or their failure to perform
f. Adverse tax opinions or events affecting the tax exempt status of the security
g. Modifications to rights of security holders
h. Bond Calls
i. Defeasances
j. Matters affecting collateral
k. Rating changes

3. Dissemination

As discussed above, the municipal market today lacks an effective mechanism for dissemination of material information to investors and the marketplace. To be effective in minimizing the issuer's risk under the antifraud provisions, the annual financial information and event disclosure should be disseminated in a manner reasonably designed to inform the holders of the issuer's securities and the market for those securities.

Trustees can serve as cost effective disseminators of information to the market due to the capacity and duties of trustees under the terms of the indentures, which positions them to have knowledge of the events requiring disclosure, and the ability and authority to communicate with bond-holders.[100] The Commission encourages the inclusion of provisions in trust indentures that authorize trustees to transmit information to the market, particularly in structured financings where the issuer's obligations generally are delegated to various participants. Trustees also may provide a service to other small issuers, by enabling them to notify the market in a timely manner and at a lower cost.

The common denominator for current proposals to improve secondary market disclosure for municipal securities is the establishment and designation of one or more information repositories to serve as a collection and access point for annual and current information.[101] Such repositories would serve as predetermined sources for information concerning a particular issuer, allowing participants to verify that they have the latest available information concerning the issuer before recommending, purchasing, or bidding for a security. The repositories would supplement, not substitute for, the existing access bond holders may have to issuers to obtain current information.[102]

In the accompanying release, the Commission is proposing an amendment to Rule 15c2-12 to prohibit, as suggested by the Joint Statement, underwriting of a municipal securities issue unless the issuer of the municipal security has covenanted to provide annual and ongoing disclosure to a repository.

V. INTERPRETIVE GUIDANCE WITH RESPECT TO OBLIGATIONS OF MUNICIPAL SECURITIES DEALERS

In the Proposing and Adopting Releases for Rule 15c2-12, the Commission set forth its interpretation of the obligation of municipal underwriters under the antifraud provisions of the federal securities laws. The interpretation discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of statements made in connection with the offering. The interpretation was set out in the Proposing Release, and modified slightly in the Adopting Release. The Commission reaffirms its

[99] In 1990, the American Bankers Association Corporate Trust Committee drafted a proposal identifying 16 factors that it believed were important for issuers to disclose to bondholders and the marketplace. American Bankers Association Corporate Trust Committee, *Proposed Disclosure Guidelines for Corporate Trustees* (ABA Draft for Discussion Purposes) (June 12, 1990) ("ABA 1990 Guidelines"). As published in final form in September of 1991 ("ABA 1991 Guidelines"), the Guidelines contained a nonexclusive list of five types of events that could be disclosed by notice to a repository. Numerous market participants have referenced the ABA draft proposal, or variations of that proposal, as a starting point for identifying straight-forward, non-judgmental, categories of events that call for prompt disclosure. An addendum to the Joint Statement provided four examples of "significant information" that the participants considered appropriate for disclosure. The nonexclusive examples were (1) nontechnical defaults, (2) draws from a debt service reserve fund, (3) failure to make a regularly scheduled payment, and (4) any draws on any credit enhancement. Joint Statement, Addendum. The list set forth above is drawn from these proposals.

[100] *See* ABA 1991 Guidelines at 3.

[101] Consistent with the recent recommendation of the Joint Statement, the GFOA Guidelines call for lodging secondary market disclosure with a repository, as did the ABA guidelines published in 1991. GFOA Guidelines, Procedural Statement No. 8; ABA 1991 Guidelines at 3.

[102] The American Bankers Association Corporate Trust Committee and the National Association of Bond Lawyers, as well as the Joint Statement, have expressed concern that securities depositories and their participants do not retransmit notices they receive from trustees and issuers to the beneficial owners of the issuer's securities. The ABA Corporate Trust Committee sought to address the problem by calling for simultaneous dissemination of the information to the marketplace through an information repository. The National Association of Bond Lawyers has suggested that the Commission promulgate a rule mandating that all depositories and their direct and indirect participants promptly retransmit notices received from the issuer or indenture trustee. While the establishment of information repositories may address the problem to some extent, the Commission staff intends to work with the relevant organizations to assure that steps are taken to provide for consistent retransmission of the information.

Interpretation with respect to underwriters' responsibilities under the antifraud provisions of the federal securities laws.[103]

Furthermore, the Commission believes that it is also appropriate to emphasize the responsibilities of brokers and dealers in trading municipal securities in the secondary market. The Commission historically has taken the position that a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for the recommendation.[104] A dealer, unlike an underwriter, ordinarily is not obligated to contact the issuer to verify information. A dealer must, however, have a reasonable basis for its recommendation.[105] If, based on publicly available information, a dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for further inquiry, a municipal securities dealer may need to obtain additional information, or seek to verify existing information.[106]

One of the rules proposed simultaneously with the issuance of this release would require a broker, dealer or municipal securities dealer to review current information provided by the issuer prior to recommending a transaction in a municipal security. In the absence of such current information, the dealer could not recommend a transaction in the issuer's securities. That rule, which would be applicable to municipal securities issued subsequent to the effective date of the proposed rule, would reinforce the obligations of dealers under the antifraud provisions of the federal securities laws to have a reasonable basis for recommendations of outstanding municipal securities.

The Joint Statement also called for a strengthening of the suitability rules to require disclosure of ratings and whether the issuer has committed to provide annual financial reports. Today, the Commission is proposing amendments to its confirmation rules to require disclosure of the absence of a rating in confirmations. The MSRB has indicated it has under consideration a plan requiring municipal securities dealers to disclose to their customers the importance of secondary market information and whether the issuer has agreed to voluntarily provide such disclosures.[107] The Commission will defer to the MSRB's reexamination of its suitability rules in implementing those aspects of the Joint Statement.

VI. REQUEST FOR COMMENTS

The Commission intends to continue to monitor developments in municipal securities disclosure practices. Comment is requested regarding the disclosure items discussed in this release, and in particular, items warranting event disclosure. Comment also is requested regarding additional action that should be taken with respect to disclosure in the municipal securities market by the Commission, the MSRB, or Congress.

VII. AMENDMENT OF THE CODE OF FEDERAL REGULATIONS

List of Subjects in 17 CFR Parts 211, 231 and 241
Securities

PART 211 - INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

PART 231 - INTERPRETIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

PART 241 - INTERPRETIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

Parts 211, 231 and 241 of title 17, chapter II of the Code of Federal Regulations are amended by adding each of the following Release Nos. and the release date of March 9, 1994, to the list of interpretive releases in each part: FR-42; 33-7049; 34-33741. By the Commission.

Jonathan G. Katz
Secretary

Dated: March 9, 1994

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[103] In light of the underwriter's obligation, as discussed in the prior releases, to review the official statement and to have a reasonable basis for its belief in the accuracy and completeness of the official statement's key representations, disclaimers by underwriters of responsibility for the information provided by the issuer or other parties, without further clarification regarding the underwriter's belief as to accuracy, and the basis therefor, are misleading and should not be included in official statements.

[104] *See Donald T. Sheldon*, Securities Exchange Act Release No. 31475 (Nov. 18, 1992); *Elizabeth Bamberg*, Securities Exchange Act Release No. 27672 (Feb. 5, 1990); *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Nassar & Co.*, Securities Exchange Act Release No. 15347 (Nov. 22, 1978). *See also* Proposing Release, 53 FR at 37787, n.72-73.

[105] *Richard J. Buck & Co.*, 43 SEC 998 (1968), *aff'd sub nom. Hanley v. SEC*, 416 F.2d 589 (2d Cir. 1969). *See also* The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures, Securities Act Release No. 5275 (Aug. 9, 1972) 37 FR 16011, 16012-13; *In Re Blumenfeld*, Securities Exchange Act Release No. 16437 (Dec. 19, 1979) (broker-dealer charged unfair mark-ups and recommended transactions in municipal securities without a reasonable basis); *J.A. Winston & Co., Inc.*, 42 S.E.C. 62 (1964) (broker-dealer recommended transactions without a reasonable basis, and made representations that were false and misleading).

[106] *See Merrill, Lynch, Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an objective analysis [which] can only be achieved when the scope of an investigation is extended beyond the company's management); *John R. Brick*, Securities Exchange Act Release No. 11763 (Oct. 24, 1975) ("the professional...is not an issuer. But he is under a duty to investigate and see that his recommendations have a reasonable basis"); *M.G. Davis & Co.*, 44 SEC 153, 157-58 (1970) (broker-dealer registration revoked because "representations and predictions" made and market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the [market letter] without further investigation"), *aff'd sub nom. Levine v. SEC*, 436 F.2d 88 (2d Cir. 1971). *See also Merrill, Lynch, Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) (noting that if a broker-dealer lacks sufficient information to make a recommendation, the lack of information is material and should be disclosed).

[107] *See supra* n. 62.

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 240
Release No. 34-33742; File No. S7-5-94
RIN 3235-AG13
MUNICIPAL SECURITIES DISCLOSURE
AGENCY: Securities and Exchange Commission.
ACTION: Proposed rulemaking.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is publishing for comment proposed amendments to Rule 15c2-12 under the Securities Exchange Act of 1934 ("Exchange Act"), which would make it unlawful for a broker, dealer, or municipal securities dealer to act as an underwriter of an issue of municipal securities unless the broker, dealer, or municipal securities dealer has reasonably determined that the issuer or its designated agent has undertaken in a written agreement or contract for the benefit of the holders of such municipal securities to provide certain information to a nationally recognized municipal securities information repository; or to recommend the purchase or sale of a municipal security, without having reviewed the information the issuer of the municipal security has undertaken to provide. The purpose of the proposed amendments is to further deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available.

DATES: Comments must be received on or before July 15, 1994.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7-5-94. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Esq., Chief Counsel, or Janet W. Russell-Hunter, Esq., Attorney, Office of Chief Counsel (concerning the rule and release generally), (202) 504-2418, Division of Market Regulation, Securities and Exchange Commission, Mail Stop 7-10, 450 Fifth Street, N.W., Washington, D.C. 20549; and Amy Meltzer Starr, Esq., Attorney, Division of Corporation Finance (concerning the definitions of "final official statement" and "significant obligor," and concerning annual financial information and material events generally), (202) 272-3654, Division of Corporation Finance, Securities and Exchange Commission, Mail Stop 7-6, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

In a recent report to Congress,[1] the staff of the Division of Market Regulation ("Staff") reviewed many aspects of the municipal securities market, including whether opportunities exist for overreaching and investor deception. The Staff found that investors need sufficient current information about issuers and significant obligors to better protect themselves from fraud and manipulation, to better evaluate offering prices, to decide which municipal securities to buy, and to decide when to sell.[2] Moreover, the Staff found that the growing participation of individuals as both direct and indirect purchasers of municipal securities underscores the need for sound recommendations by brokers, dealers, and municipal securities dealers.[3]

Based on these findings, the Staff recommended that the Commission use its interpretive authority to provide guidance regarding the disclosure required by the antifraud provisions of the federal securities laws.[4] Today, in a companion release,[5] the Commission is interpreting the disclosure obligations of municipal securities issuers. The Companion Release also addresses the obligations under the antifraud provisions of brokers, dealers, and municipal securities dealers who underwrite and sell municipal securities, and the information dissemination requirements of Rule 15c2-12.[6]

In addition, the Staff recommended in the *Staff Report* that Rule 15c2-12 be amended, or that similar rules be adopted, to

[1] Securities and Exchange Commission, Division of Market Regulation, *Staff Report on the Municipal Securities Market* (Sept. 1993) ("*Staff Report*"). The *Staff Report* was prepared at the request of the Hon. John D. Dingell, Chairman, Committee on Energy and Commerce, United States House of Representatives, and the Hon. Edward Markey, Chairman, Subcommittee on Telecommunications and Finance, United States House of Representatives. Among the topics discussed in the *Staff Report* were political contributions, sales practices, transparency, audit trails, issuer disclosure, and the regulatory structure for municipal securities. *See* Letter from Hon. John D. Dingell, Chairman, Committee on Energy and Commerce, and Hon. Edward Markey, Chairman, Subcommittee on Telecommunications and Finance to: Mary L. Schapiro, Acting Chairman, SEC; Christopher A. Taylor, Executive Director, Municipal Securities Rulemaking Board ("MSRB"); and Joseph R. Hardiman, President and Chief Executive Officer, National Association of Securities Dealers, Inc. ("NASD") (May 24, 1993).

[2] *Staff Report*, *supra* note 1 at 38.

[3] *Id.* at 28.

[4] *Id.* at 40. Section 17(a) of the Securities Act of 1933 ("Securities Act"), and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, apply to "persons," including issuers of municipal securities.

[5] Securities Act Release No. 7049, Exchange Act Release No. 33741, FR-42 (March 9, 1994) ("Companion Release").

[6] 17 CFR 240.15c2-12. *See* Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778 ("Proposing Release"); Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("Adopting Release"). Rule 15c2-12 requires an underwriter of municipal securities (1) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer, prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (3) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (4) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of MSRB rules. Rule 15c2-12 also contains specific exemptions for three types of municipal securities offerings.

prohibit municipal securities dealers from recommending outstanding municipal securities unless the issuer has committed to make available ongoing information regarding its financial condition.[7] This release proposes to implement the Staff's recommendation.

Section 15(c)(2) of the Exchange Act prohibits municipal securities dealers from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any municipal security by means of a "fraudulent, deceptive, or manipulative act or practice."[8] This section specifically authorizes the Commission to promulgate rules and regulations to define, and prescribe means reasonably designed to prevent, such acts and practices. Pursuant to this authority, the Commission adopted Rule 15c2-12 in 1989 for the purpose of preventing fraud by enhancing the quality, timing, and dissemination of disclosure in the municipal securities market.[9]

The Commission proposes to amend Rule 15c2-12 to further deter fraud and manipulation in the primary and secondary municipal securities markets by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available.[10] For many years, the courts and the Commission have emphasized that, under the antifraud provisions, a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for making the recommendation.[11] In the Proposing Release and the Adopting Release, the Commission discussed broker-dealers' obligation to have a reasonable belief in the accuracy of statements made when underwriting securities.[12] When recommendations in the secondary market are made, they must be based on information that is up-to-date and accessible.

The proposed amendments to Rule 15c2-12 will assist brokers, dealers, and municipal securities dealers in satisfying their obligations under the antifraud provisions of the federal securities laws, and specifically under Section 15(c)(2), by conditioning the underwriting and recommendation of municipal securities on the availability of current issuer information. By providing an efficient and timely means of access to disclosure, the proposed amendments will ensure that information will be available in the future regarding underwritten securities. As a result, brokers, dealers, and municipal securities dealers will be better able to recommend municipal securities in the secondary market based on current issuer information. Fraud and manipulation in both the primary and secondary markets for municipal securities thus will be deterred. Furthermore, the availability of secondary market disclosure to all municipal securities market participants will assist investors in protecting themselves from misrepresentation or other fraudulent activities by brokers, dealers, and municipal securities dealers.

For these reasons, the Commission proposes to amend Rule 15c2-12 to prohibit a broker, dealer, or municipal securities dealer ("Participating Underwriter")[13] from purchasing or selling municipal securities in connection with a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more ("Offering")[14] unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken in a written agreement or contract for the benefit of the holders of such municipal securities to provide certain information to a nationally recognized municipal securities information repository ("NRMSIR"). The prohibition would apply to underwriters that have committed contractually to act as an underwriter in an Offering on or after the effective date of the rule amendment. This proposal responds, in part, to a suggestion in the *Joint Statement on Improvements in Municipal Securities Market Disclosure*,[15] in which a broad spectrum of municipal securities market

[7] *Staff Report*, *supra* note 1 at 40. *See also* Testimony of Arthur Levitt, Chairman, SEC, Concerning the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (Sept. 9, 1993) at 5-7; Remarks of Arthur Levitt, Chairman, SEC, The Bond Buyer Ethics in Public Finance Conference (Jan. 24, 1994) at 6; Remarks of Richard Y. Roberts, Commissioner, SEC, "Alternatives for Improving Municipal Secondary Market Disclosure," The Southern Municipal Finance Society 13th Annual Fall Conference (Sept. 15, 1993) at 9-12.

[8] Exchange Act Section 15(c)(2), 15 U.S.C. 78o(c)(2).

[9] *See* Adopting Release, *supra* note 6 at 54 FR 28800.

[10] Under the antifraud provisions of the federal securities laws, issuer disclosure not only must be accurate in all material respects, but also must not omit information necessary to make the statements made, in light of the circumstances, not misleading. The proposed amendment will assist issuers in satisfying their obligations under the antifraud provisions by creating a mechanism for the dissemination of primary and secondary market disclosure. *See* Companion Release, *supra* note 5 at Section III.A.

[11] *See e.g. Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Cortlandt Investing Corporation*, 44 SEC 45 (1969); *Crow, Bourman & Chotkin, Inc.*, 42 SEC 938 (1966); *Shearson, Hammill & Co.*, 42 SEC 811 (1965).

[12] *See* Proposing Release, *supra* note 6 at 53 FR 37787; Adopting Release, *supra* note 6 at 54 FR 28811. *See also See Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1069-70 (7th Cir. 1973) (noting underwriter's heightened obligation when it has an opportunity to require disclosure from the issuer, and when there are special selling pressures involved in underwriting a security), *vacated and remanded on other grounds*, 425 U.S. 929 (1976), *on remand*, 554 F.2d 790 (7th Cir. 1977), *reh'g denied*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied* 450 U.S. 1005 (1981); *Donaldson, Lufkin & Jenrette Securities Corp.*, Securities Exchange Act Release No. 31207 (Sept. 22, 1992); *Hamilton Grant & Co.*, Securities Exchange Act Release No. 24679 (July 7, 1987); *Walston & Co.*, Securities Exchange Act Release No. 8165 (Sept. 22, 1967) (stating that it is incumbent on dealers participating in offerings, as well as on dealers recommending municipal bonds, to make a diligent inquiry as to material facts relating to the issuer and bearing on the issuer's ability to service the bonds).

[13] *See* Rule 15c2-12(a).

[14] The proposed amendments also include an exemption for small and infrequent issuers. *See* Section II.D., *infra*.

[15] *Joint Statement on Improvements in Municipal Securities Market Disclosure* (Dec. 20, 1993) ("*Joint Statement*") at 2-3. The Joint Statement was issued by twelve groups representing participants in all aspects of the municipal securities market. The groups included were the American Bankers Association's Corporate Trust Committee; the American Public Power Association; the Association of Local Housing Finance Agencies; the Council of Infrastructure Financing Authorities; the Government Finance Officers Association; the National Association of Bond Lawyers; the National Association of Counties; the National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Treasurers; the National Council of State Housing Agencies; the National Federation of Municipal Analysts; and the Public Securities Association.

participants supported wider dissemination of issuer information and improved mechanisms for such dissemination, to assure that securities professionals have a sufficient factual basis on which to recommend secondary market transactions.

The Commission is proposing further to amend Rule 15c2-12 to require brokers, dealers, and municipal securities dealers, prior to recommending the purchase or sale of a municipal security, to review the information the issuer of the municipal security has undertaken to provide. This amendment would apply to municipal securities issued on or after the effective date of the proposed amendment discussed in the preceding paragraph.

Finally, the proposed amendments would define the term "significant obligor," and amend the definition of the term "final official statement" for purposes of Rule 15c2-12.

II. DESCRIPTION OF THE PROPOSED AMENDMENTS TO RULE 15c2-12

A. Underwriting Requirement

One amendment proposed today would add paragraph (b)(5) to Rule 15c2-12. This paragraph would prohibit a Participating Underwriter from purchasing or selling municipal securities in connection with an Offering, unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken in a written agreement or contract for the benefit of holders of such municipal securities to provide certain information to a NRMSIR. In using the terms "purchase" or "sale," the proposed amendment contemplates that, at such time as the issuer of municipal securities delivers the securities to the Participating Underwriters, the issuer will have undertaken, in a written contract or agreement for the benefit of holders of the municipal securities, to provide information to a NRMSIR.[16]

With the exception of general obligation bonds, most offerings include a trust indenture which sets forth the undertakings between the issuer and the holders of municipal securities, and thus delineates the bondholders' rights. If there is no trust indenture, as in a general obligation bond offering, a bond resolution, ordinance, or written agreement or contract sets out the undertakings by the issuer for the benefit of the holders of the municipal securities. In order to satisfy its obligation under the rule, a Participating Underwriter would need to look to these documents for undertakings by the issuer to supply secondary market disclosure to a NRMSIR. A Participating Underwriter will have satisfied its obligation under proposed paragraph (b)(5), so long as it can conclude that all of the appropriate undertakings have been made. While the issuer's duty will be to its bondholders, all participants in the municipal securities market will benefit from having access to this information.

Comment is requested on the use of a written agreement or contract for the provision of secondary market information by issuers for the benefit of holders of municipal securities, particularly in light of the provisions of proposed paragraph (c) prohibiting the recommendation by brokers, dealers, and municipal securities dealers of municipal securities when issuer information is unavailable. Comments should address specifically the consequences of a failure by an issuer to comply with its secondary market disclosure undertakings after the initial issuance of municipal securities. Comment is requested on whether the use of the issuer's undertakings is a necessary or appropriate approach to implementing procedures for providing information to the municipal securities market. Comment also is requested on whether, as an alternative to written undertakings, a statement in the final official statement of the issuer of municipal securities that it will provide secondary market disclosure would be sufficient. In addition, commenters are requested to address whether the use of written undertakings provides sufficient flexibility for issuers that, in the future, wish to change the type, timing, or presentation of the information, or whether some alternative mechanism should be used.

1. Annual Information

Proposed paragraph (b)(5)(i)(A) would prohibit Participating Underwriters from purchasing or selling municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken to provide to a NRMSIR, at least annually, current financial information concerning the issuer of the municipal security and any significant obligors, including annual audited financial statements and pertinent operating information.

Current annual financial information is an important source of updated information for the market. The format for presenting such information is not specified in the proposed amendment, and may be accomplished through any disclosure document, whatever its form or principal purpose, that includes annual audited financial statements and pertinent operating information. The proposed amendment contemplates that sequential final official statements prepared by frequent issuers of municipal securities may meet the standards of the rule. Similarly, the audited financial statements should fairly present the current financial condition, the results of operations, and cash flows of the municipal issuer and any significant obligor. Proposed paragraph (b)(5) also does not dictate the content of the annual financial information, other than the audited financial statements. Rather, it provides discretion to offering participants.

The Commission recognizes that there is great diversity in the municipal marketplace, both in terms of the types of issuers and the types of issues of municipal securities. The proposed amendment is, therefore, intended to permit issuers the flexibility to address the needs of the market by specifying in the written agreement or contract the particular financial and operating information that is to be provided on an annual basis, in addition to the annual audited financial statements. The Commission anticipates that issuers and offering participants will look to various voluntary guidelines, as well as the guidance provided in the Companion Release, in establishing an appropriate level of disclosure for each municipal securities issue. Of course, additional information, such as unaudited quarterly information, also could be specified.

Under the proposed amendment, in paragraph (b)(5)(ii), the issuer of the municipal security also would be required to specify

[16] A Participating Underwriter would need to receive assurances from the issuer that such undertakings would be made before agreeing to act as an underwriter.

what accounting principles will be used in the preparation of the audited financial statements, the time within which the annual information for each year will be available, and the specific operating and financial information that will be provided on an annual basis, in addition to the audited financial statements. The covenant would not limit the issuer in its ability to supplement the specific information, where necessary or appropriate.

Proposed paragraph (b)(5)(ii) does not specify the timing of availability of the annual financial information in each year. Rather, any written contract or agreement would be required to specify the annual time frame in which the current financial information covering the previous fiscal year will be provided by the issuer of the municipal security and any significant obligors. As noted above, this permits issuers some flexibility in disseminating this information, and also allows investors and the marketplace to know when such information will be available.

Comment is requested on whether the rule should specify the minimum content of the information to be provided on an annual basis. Comment is requested on whether audited financial statements should be required, and whether they should be required to be audited using GAAS. Comment also is requested on whether the financial statements should be required to conform to generally accepted accounting principles ("GAAP") or should include discussions of material deviations from GAAP if prepared on some other basis. Further, comment is requested on whether the rule should specify the time frame, such as six months or nine months after the fiscal year and, in which the annual financial information should be made available in each year.

2. Material Events

Proposed paragraph (b)(5)(i)(B) requires that Participating Underwriters assure themselves that issuers have undertaken to provide, in a timely manner, notice of any of the following events, if material:

(1) principal and interest payment delinquencies;
(2) non-payment related defaults;
(3) unscheduled draws on debt service reserves reflecting financial difficulties;
(4) unscheduled draws on credit enhancements reflecting financial difficulties;
(5) substitution of credit or liquidity providers, or their failure to perform;
(6) adverse tax opinions or events affecting the tax-exempt status of the security;
(7) modifications to rights of security holders;
(8) bond calls;
(9) defeasances;
(10) matters affecting collateral; and
(11) rating changes.

This portion of the proposed amendment, like that addressing annual financial information, is intended to provide guidance to issuers and other participants in the municipal securities market regarding the dissemination of notices of material events. As discussed in the Companion Release,[17] this list consists of recognized material events that reflect on the creditworthiness of the issuer of the municipal security or any significant obligor, as well as on the terms of the securities they issue. The issuer must determine whether information needs to be disseminated about a listed event in any particular situation, and if so, when the information dissemination should occur in order to be "timely." For example, an issuer would be free to determine that a *de minimis* draw on a reserve fund by an issuer financing agency resulting from a delay by the obligor in transmitting a payment, where the draw is replaced immediately and is not the result of the obligor's financial difficulties, is not a material event requiring notice to the market.

Comment is requested as to whether the listed items of material events should be expanded. Comment also is requested on whether timing, for example, within a certain number of days, for the dissemination of notice of these events should be specified as part of the undertaking.

B. Recommendations Without Specified Information

As proposed, a new paragraph (c) would be added to the rule, which would prohibit any broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has reviewed the information the issuer of such municipal security has undertaken to provide pursuant to paragraph (b)(5).

As noted above, broker-dealers imply by recommending securities that they have a reasonable basis for making such recommendations. In the Commission's view, most situations in which a broker, dealer, or municipal securities dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer.

The proposed amendment neither specifies the form in which information must be reviewed, nor specifies which documents must be obtained.[18] Rather, it requires brokers, dealers, and municipal securities dealers to review the information that the issuer of the municipal security has agreed to provide. The proposed amendment is intended to allow this information to be obtained and reviewed through any means of dissemination used by participants in the municipal securities market.[19] While the information may

[17] Companion Release, *supra* note 5, at Section IV.B.2.

[18] *C.f.* Rule 15c2-11, 17 CFR 270.15c2-11. Rule 15c2-11 requires that brokers and dealers, prior to entering quotations for securities in a "quotation medium", have in their records certain specific information, and, based on a review of this information, have a reasonable basis under the circumstances for believing that the information is accurate in all material respects, and that the sources of the information are reliable. Submissions of quotations respecting municipal securities are exempt from the application of Rule 15c2-11. Rule 15c2-11(f)(4).

[19] Therefore, brokers, dealers, and municipal securities dealers could review information received through electronic dissemination, in response to telephone inquiries, facsimile, by mail, or by messenger service, so long as the information is complete.

be available from documents placed in a NRMSIR, this may not be the only source of information. Thus, to satisfy the requirements of the rule, brokers, dealers, and municipal securities dealers may obtain this information directly from the issuer, from professionals such as attorneys, accountants, or other municipal securities dealers, or from any other reliable source. If, in reviewing this information, they discover any factors that suggest that disclosure is inaccurate or incomplete, or that signal the need for additional investigation, brokers, dealers, and municipal securities dealers may need to obtain additional information, or seek to verify existing information.[20] If, however, the rating is known and information placed with a NRMSIR has been reviewed and raises no questions, a broker, dealer, or municipal securities dealer would need to look no further for information about the security recommended. Furthermore, a broker, dealer, or municipal securities dealer would not be prohibited from recommending the purchase or sale of a municipal security solely because of the existence of material events of which, after its review, it has no knowledge. This could occur if an issuer failed to disclose the occurrence of a material event to a NRMSIR or to disseminate notice of such an occurrence in any other manner. Under paragraph (c), if the specified information is not available, no recommendation may be made.

Comment is requested on the provisions of proposed paragraph (c). Specifically, comment is requested on the application of the term "recommend," and whether the requirement to review information is burdensome, or requires further clarification.

In view of the importance of ensuring the secondary market liquidity of municipal issues, comment also is requested on whether market participants believe that the proposed amendments would have a substantial or long-lasting effect on market liquidity. Questions have been raised about whether municipal securities dealers will be willing to effect secondary market transactions in a broad range of municipal securities in light of the specificity with which the requirement of paragraph (c) is articulated. The Commission is of the view that once the proposed amendments are in effect, and dissemination systems are operating, liquidity will not be affected, and that municipal securities dealers will be willing and able to purchase and sell as broad a range of securities as before. Commenters should consider this analysis and suggest any factors that may have effects on liquidity, and what operational changes or repository arrangements, or changes to the proposed amendment to the rule, would reduce these effects.

C. Definitions

1. Final Official Statement

Rule 15c2-12(e)(3) presently defines the term "final official statement" as a document or set of documents prepared by the issuer or its representatives setting forth information concerning the issuer and the securities to be issued that is complete as of the date the document is delivered to the Participating Underwriter. The definition does not prescribe the specific information required to be included in the documents. In order to ensure that the purposes of Rule 15c2-12 are met, and in light of the proposed amendment obligating Participating Underwriters to assure that issuers have undertaken to provide to a repository issuer-identified minimum annual financial information, as well as notices of material events, the Commission is proposing to amend the definition of final official statement to include an information requirement. The definition of final official statement also governs the items of information to be included in the near final official statement, subject to availability considerations.[21] Having a standard with which to compare the contents of near final official statements should assist Participating Underwriters in satisfying their obligation to have a reasonable basis on which to recommend securities.[22]

The proposed amendment would define the final official statement to include information concerning the terms of the proposed issue of securities, and financial and operating information concerning the issuer that is adequate to provide a fair presentation of the issuer's current financial condition and results of operations and cash flows, including audited financial statements. Financial and operating information also would be required for any "significant obligor" with respect to the municipal security. The term "significant obligor" is defined in the proposed amendment, and is discussed below. As discussed in the Companion Release, reliable financial information, prepared on a consistent basis, that fairly presents the issuer's and any significant obligor's financial position, is an important component of a disclosure scheme designed to prevent fraud.

Comment is requested on whether an amendment to the definition of final official statement is necessary. If commenters consider amendment necessary, comment is requested on whether audited financial statements should be required, whether audited financial statements should be required to be audited using GAAS, the number of years of audited financial statements that should be included, if any, and if audited financial statements are included, whether unaudited financial statements covering interim periods also should be included. Comment also is requested on whether the definition should be amended to require that the financial statements conform to GAAP, or should include discussions of material deviations from GAAP if prepared on some other basis.

The final official statement can be composed of a set of documents. Comment is requested on whether a seasoned issuer

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[20] *See M.G. Davis & Co.*, 44 SEC 153, 157-58 (1970)(broker-dealer registration revoked because "representations and predictions" made and, market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the [market letter] without further investigation"), *aff'd sub nom. Levine v. SEC*, 436 F.2d 88 (2d Cir. 1971); *Merrill, Lynch, Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) (noting that if a broker-dealer lacks sufficient information to make a recommendation, the lack of information is material and should be disclosed). *See also* Companion Release, *supra* note 5 at Section V (discussing the obligations of brokers, dealers, and municipal securities dealers to investigate information in order to have a reasonable basis for making a recommendation).

[21] *See Public Securities Association* (Aug. 24, 1992) (interpretation regarding the information to be contained in near final official statement obtained and reviewed by underwriters pursuant to Rule 15c2-12(b)(1)).

[22] For a discussion of the delivery requirement of a near final official statement pursuant to Rule 15c2-12(b)(1), *see* Companion Release, *supra* note 5, at Section III.E.6.

should be permitted to incorporate previously prepared documents by reference into the final official statement and, if incorporation by reference is permitted, what limitations or requirements should be imposed. Comment is requested on whether seasoned issuers should be required to provide documents incorporated by reference upon request and at no charge, and on what definition should be used for "seasoned issuers." For example, seasoned issuers could be defined as repeat issuers having in excess of a specified dollar amount of outstanding securities.

2. Significant Obligors

Proposed paragraph (b)(5) of the amendment would require financial and operating information on "significant obligors" of an issuer of a municipal security to be provided in the final official statement and in annual financial information. The proposed amendments, in paragraph (f)(9), also would define the term "significant obligor."

An obligor is any person who, directly or indirectly, under a lease, loan, sale, or other agreement or arrangement, is obligated to make payments to the issuer, which cash payments are the source of the cash flow servicing the obligations on municipal securities. The term "obligor" is not limited to issuers of separate securities under Rule 3b-5 under the Exchange Act and Rule 131 under the Securities Act.[23] Under the proposed definition, an obligor would be viewed as "significant" if it is the source of 20 percent or more of the cash flow servicing the obligations on the municipal securities.

This definition is designed to make available to the municipal securities market, at the time of issuance and on an annual basis, information on persons who ultimately are responsible for the cash flow servicing the municipal securities. The proposed definition recognizes that, with portfolio and concentration risk diversification, the "significant obligor" of an issuer of a municipal security may not be constant, but may change from year to year.

Comment is requested on whether 20 percent is an appropriate threshold level of cash flow to require disclosure concerning a significant obligor, or whether a different threshold, such as 10, 15, or 30 percent, should be used. Comment also is requested on whether this standard should differ for a final official statement and annual financial information. Finally, comment is requested as to whether the issuer's obligation to provide information concerning significant obligors should be conditioned on a minimum threshold, for example, payment obligations in excess of $1,000,000, or some other dollar threshold.

D. Exemptions

Consistent with other provisions of Rule 15c2-12, the proposed amendments are limited in application to primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more.

The proposed amendments include a new exemption in paragraph (d)(2), applicable to paragraph (b)(5). This new exemption would provide that, in addition to the $1,000,000 threshold applicable to Rule 15c2-12 generally, Offerings would be exempt from the operation of paragraph (b)(5) if, at such time as the issuer of municipal securities delivers the securities to the Participating Underwriter, the issuer: (a) will have less than $10,000,000 in aggregate amount of municipal securities outstanding, including the offered securities; and (b) the issuer will have issued less than $3,000,000 in aggregate amount of municipal securities in the most recent 48 months preceding the Offering. This exemption is designed to exclude from the application of paragraph (b)(5) small issuers that do not frequently issue municipal securities. Comment is requested on the use of these thresholds. Comment also is requested on whether a different or additional threshold should be applicable to paragraph (b)(5). Such a threshold could be based on the number of holders of municipal securities, or on the number of holders falling below a certain level at the end of a fiscal year, for example, 300 or 500 debt holders. Comment is requested on whether issuers of conduit securities that are non-governmental private activity bonds should be excepted from this exemption, or if lower or different thresholds should be used for such issuers. Comment also is requested on whether the exemption in proposed paragraph (d)(2) is appropriate for conduit financings, in light of the fact that, in many instances, issuing authorities are created for the sole purpose of issuing bonds to finance a particular facility.

The proposed amendments also include a new exemption in paragraph (d)(3), exempting from the application of paragraph (c) of the rule a primary offering of municipal securities (1) not sold in an Offering to which paragraph (b)(5) applied, or (2) sold in an Offering exempt under paragraph (d)(1) or paragraph (d)(2). The purpose of this exemption is to permit the recommendation in the secondary market of securities that were not subject to paragraph (b)(5), either because they were sold in a primary offering of municipal securities with an aggregate principal amount of less than $1,000,000, or because they came within the existing exemptions under newly designated paragraph (d)(1) for limited placements, short-term securities, and securities with demand features, or within the exemption in new paragraph (d)(2) for small, infrequent issuers. Comment is requested on this exemption. Specifically, comment is requested on whether paragraph (c) of the proposed amendments should be made applicable to all outstanding issues of municipal securities. The existing transactional exemption in newly designated paragraph (d) would apply to the amendments.

E. Transitional Provision

Newly designated paragraph (g) of the rule would contain a transitional provision for the proposed amendments. The provisions of paragraph (b)(5) would apply to a Participating Underwriter that had contractually committed to act as an underwriter in an Offering on or after the effective date of the rule. Comment is requested on whether this transitional provision is appropriate, and on whether the effective date of the proposed amendments should be delayed.

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[23] An obligor is not only an industrial or commercial enterprise, but may include governmental and nonprofit entities as well. *See* the definition of issuer in Rule 15c2-12(e)(4), 17 CFR 240.15c2-12(e)(4); Rule 3b-5, 17 CFR 240.3b-5, and Rule 131, 17 CFR 230.131, under the Securities Act.

III. NATIONALLY RECOGNIZED MUNICIPAL SECURITIES INFORMATION REPOSITORIES

While the term "NRMSIR" currently is used in paragraph (b)(4) of Rule 15c2-12, it is not defined in the rule. In proposing the rule, however, the Commission requested comment on the creation of one or more repositories for municipal securities disclosure documents.[24] At that time, the Commission strongly supported the development of one or more central repositories.[25] Of the more than sixty comment letters that the Commission received, forty-five expressed views regarding the concept of repositories. Forty of the forty-five commenters expressed support for some form of a central repository.[26]

NRMSIRs were discussed in the Adopting Release, where the Commission noted that in determining whether a particular entity is a NRMSIR, it would look, among other things, at whether the repository: (1) is national in scope; (2) maintains current, accurate information about municipal offerings in the form of official statements; (3) has effective retrieval and dissemination systems; (4) places no limits on the issuers from which it will accept official statements or related information; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees.[27] The *Joint Statement* has further refined the concept to suggest the designation of state-based repositories, and the creation of an index, maintained by the MSRB, for market participants to learn of the availability of information provided to the MSRB or to a NRMSIR.[28]

The proposed amendments do not define the term NRMSIR. The Commission requests comment on whether NRMSIR should be defined in the rule, with specific standards established for NRMSIRs. If standards were established, the Commission believes the following standards are appropriate. It requests comment on these standards.

NRMSIRs should maintain current, accurate information about municipal securities, including final official statements, the issuers' annual financial information, and issuers' notices of material events. Moreover, NRMSIRs should have effective systems for the timely collection, indexing, storage, and retrieval of these documents.

NRMSIRs should be capable of national dissemination of final official statements, annual financial information, and notices of material events through electronic dissemination systems, in response to telephone inquiries, and hard copy delivery via facsimile, by mail, and by messenger service. Specific dissemination systems and standards should be delineated in order to emphasize the importance of effective information dissemination. Timely public availability upon receipt of information by a NRMSIR also is important. For example, final official statements and annual financial information could be made available by the next business day after their receipt by a NRMSIR, and notices of material events could be made available within fifteen minutes of their receipt by a NRMSIR. Comment is requested on the provision by NRMSIRs of electronic dissemination of information, and on the suggested timing requirements for availability of documents for dissemination.

Repositories created and operated by states would be required to accept submissions from all issuers within their own states, and would not be permitted to accept documents from issuers in any other state. National dissemination requirements, however, would be applicable to single-state repositories. All other repositories would not be permitted to limit the issuers from which they will accept final official statements, annual financial information, and reports of material events. Comment is requested on whether state-based repositories can serve as an effective means to disseminate information to the market for a nationally traded security, so the issuer of that security can meet its disclosure obligations using a state-based repository. Comment also is requested on whether a significant number of states are willing to make the necessary financial commitment to create a state-based system. NRMSIRs would not be permitted to discriminate on the basis of the requestor in providing documents, and would be required to charge reasonable fees.

Finally, in order to implement the indexing system suggested by the *Joint Statement*, a NRMSIR would be required to provide notice to the MSRB of its designation by an issuer as the repository for the issuer's final official statements, annual financial information, and notices of material events. This would allow the creation of an index by the MSRB for informing the municipal securities market of where an issuer is sending its secondary market disclosure. Comment is requested on the feasibility of expanding this provision to require a NRMSIR to inform the MSRB whenever it receives information from an issuer. Comment also

[24] Proposing Release, *supra* note 6 at 54 FR 37791.

[25] Adopting Release, *supra* note 6 at 54 FR 28807. The Commission recognized the benefits that would accrue from the creation of competing private repositories. *Id.*

In 1989, the MSRB announced its intention to establish and manage a central repository to provide for the collection and dissemination of official statements and refunding documents. Letter from John W. Rowe, Chairman, MSRB, to Jonathan G. Katz, Secretary, SEC (June 1, 1989). The MSRB developed its Municipal Securities Information Library ("MSIL") system, which presently collects information and disseminates it electronically to market participants and information vendors.Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194.

In January 1993, the MSRB began operating its Continuing Disclosure Information pilot system ("CDI System"), which is a central repository for voluntarily submitted official continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992), 57 FR 12534. The CDI System operates as part of MSIL, and currently is capable of accepting documents of three or fewer pages in length.

Neither MSIL nor the CDI System is a NRMSIR. In considering the approval of MSRB rule G-36, which requires underwriters to provide the MSRB with copies of final official statements and certain other information prepared by issuers, the Commission noted that the MSRB did not intend to seek NRMSIR status. The Commission noted that if the MSRB sought NRMSIR status, it would consider the competitive implications of such a request. *See* Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

[26] *See* Adopting Release, *supra* note 6 at 54 FR 28807.

[27] *See* Adopting Release, *supra* note 6 at 54 FR 28808, n.65.

[28] The *Joint Statement* suggested that in order to be recognized as a NRMSIR, a repository should, among other things: (1) maintain current, accurate information about municipal securities in the form of annual financial reports, operating data, and other current information; (2) have an effective retrieval and dissemination system; (3) place no limits on the issuers from which it will accept information unless it is a single-state repository; (4) provide access to the documents to anyone willing and able to pay the applicable fee; (5) charge reasonable fees; (6) collect information on at least a state-wide basis; and (7) provide for timely notification to an MSRB index of names of issuers about which it is to receive information. *Joint Statement*, *supra* note 15 at Addendum.

is requested on whether documents should be required to be placed with the MSRB either in addition to or in lieu of a NRMSIR.[29]

The MSRB has expressed concern that permitting issuers to place documents with multiple NRMSIRs may result in repositories receiving information at different times. This raises the issue of when the information becomes "public," and thus when dealers are considered accountable for it.[30] Comment is requested on these issues, and, in particular, on how to assure that NRMSIRs simultaneously receive secondary market disclosure. Comment also is requested on whether any proposal should require that secondary market disclosure is deposited with *all* designated NRMSIRs. In addition, comment is requested on whether the proposal should designate specific methods for sending information to NRMSIRs.

Since the Commission adopted Rule 15c2-12, the Division of Market Regulation has issued three letters taking no-action positions recognizing national information vendors as NRMSIRS, based on the standards set out in the Adopting Release.[31] The Commission anticipates that if standards for NRMSIRs were adopted, these NRMSIRs, as well as new NRMSIRs, would be required to have their operations meet the new standards. Comment is requested on the ability and willingness of both potential NRMSIRs, and those presently operating under no-action letters, to meet the standards described. Furthermore, comment is requested as to whether designation by Commission order, pursuant to standards set out in Rule 15c2-12, is an appropriate method for recognizing NRMSIRs, or whether it is appropriate to continue the current no-action policies of the Division.

IV. APPLICATION OF THE TOWER AMENDMENT

With the passage of the Securities Acts Amendments of 1975 ("1975 Amendments"), Congress provided for a limited regulatory scheme for municipal securities.[32] Prior to the passage of the 1975 Amendments, municipal issuers were exempt from the registration and continuous reporting provisions of both the Securities Act and the Exchange Act. While municipal issuers continued to be exempt from all but the antifraud provisions of the federal securities laws, the 1975 Amendments required the registration of municipal securities brokers and dealers,[33] and established the MSRB,[34] granting it the authority to promulgate rules governing the sale of municipal securities.

In so crafting the 1975 Amendments, Congress struck a balance between investor protection and intergovernmental comity. This concern is reflected in Section 15B(d)(1) of the Exchange Act, which prohibits the MSRB from requiring "any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document, in connection with the issuance, sale, or distribution of such securities."[35] While narrowly tailoring the authority of the MSRB to require that disclosure documents be provided to investors,[36] Congress was careful to preserve the authority of the Commission under Section 15(c)(2) of the Exchange Act.[37]

Moreover, Section 15B(d)(2) expressly indicates that "[n]othing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title."[38] Thus, while prohibiting the Commission from requiring municipal issuers to file reports or documents prior to issuing securities in Section 15B(d)(1),[39] Congress expanded the Commission's authority to adopt rules reasonably designed to prevent fraud. The Commission believes that the proposed amendments to Rule 15c2-12 are consistent with its Congressional mandate to adopt rules reasonably designed to prevent fraud in the municipal securities market.[40]

V. EFFECTS ON COMPETITION AND REGULATORY FLEXIBILITY ACT CONSIDERATIONS

Section 23(a)(2) of the Exchange Act[41] requires the Commission, in adopting rules under the Act, to consider the anticompetitive effects of those rules, if any, and to balance that impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission preliminarily is of the view that adoption of the proposed amendments to Rule 15c2-12 would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment, however, on any competitive burdens that might result from amendment of the rule. Moreover, while the amendments apply equally to all brokers, dealers, and municipal securities dealers, the Commission is interested in receiving comments on the extent to which the proposed dollar threshold in the new exemption in paragraph (e) would

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[29] *See supra* note 25 (regarding the competitive implications of the MSRB's seeking NRMSIR status).

[30] Letter from Christopher A. Taylor, Executive Director, MSRB, to Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC (December 20, 1993).

[31] Letters from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to: Joseph V. Riccobono, Executive Vice-President, American Banker-Bond Buyer (Jan. 4, 1990); J. Kevin Kenny, President, Chief Executive Officer, J.J. Kenny Co. (Jan. 4, 1990); and Michael R. Bloomberg, President, Bloomberg, L.P. (Jan. 11, 1990).

[32] The Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975).

[33] 15 U.S.C. 78o-4(a)(1).

[34] 15 U.S.C. 78o-4(b)(1).

[35] 15 U.S.C. 78 o-4(d)(1).

[36] The so-called "Tower Amendment," adding Section 15B(d)(2), 15 U.S.C. 78o-4(d)(2) to the Exchange Act, prohibits the MSRB from requiring municipal issuers, directly or indirectly, through municipal securities broker-dealers or otherwise, to furnish the MSRB or prospective investors with any documents, including official statements. The MSRB specifically is permitted, however, to require that official statements or other documents that are available from sources other than the issuer, such as the underwriter, be provided to investors.

[37] 15 U.S.C. 78o(c)(2).

[38] 15 U.S.C. 78o-4(d)(2).

[39] 15 U.S.C. 78o-4(d)(1).

[40] Rule 15c2-12 was adopted pursuant to the Commission's authority under Exchange Act Sections 2, 3, 10, 15, 15B, and 23; 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4, 78q, and 78w.

[41] 15 U.S.C. 78w(a)(2).

burden one segment of the industry more than another.

In addition, the Commission has prepared an initial regulatory flexibility analysis ("IRFA"), pursuant to the requirements of the Regulatory Flexibility Act[42] regarding the proposed amendments to Rule 15c2-12. The IRFA indicates that the amendments to the rule could impose some additional costs on small broker-dealers and municipal issuers. Nonetheless, the Commission is of the view that many of the substantive requirements of the rule amendments already are observed by broker-dealers and issuers as a matter of business practice, or to fulfill their existing obligations under the general antifraud provisions of the federal securities laws. The Commission requests comment on the extent to which current practice deviates from the requirements of the proposed amendments, and the extent to which additional costs may be imposed on small broker-dealers and municipal issuers if the amendments are adopted as proposed.

A copy of the IRFA may be obtained from Janet W. Russell-Hunter, Esq., Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 7-10, Washington, D.C. 20549, (202) 504-2418.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, securities

Text of Proposed Amendments to Rule 15c2-12

In accordance with the foregoing, Title 17, Chapter II of Title 17 of the Code of Federal Regulations is proposed to be amended as follows:

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

2. Section 240.15c2-12 is amended by adding a Preliminary Note preceding paragraph (a); adding paragraph (b)(5); redesignating paragraph (c) through paragraph (f) as paragraph (d) through paragraph (g); adding paragraph (c); revising newly designated paragraph (d) and paragraph (f)(3); adding paragraph (f)(9); and adding one sentence to the end of newly designated paragraph (g) to read as follows:

§ 240.15c2-12 Municipal securities disclosure.

Preliminary Note: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Exchange Act Release No. 33741, FR-42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommendations of municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

* * * * *

(b) Requirements. * * *

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken in a written agreement or contract for the benefit of holders of such securities, to provide to a nationally recognized municipal securities information repository:

(A) At least annually, current financial information concerning the issuer of the municipal securities and any significant obligors, including annual audited financial statements and pertinent operating information; and

(B) In a timely manner, notice of any of the following events, if material:

(1) Principal and interest payment delinquencies;

(2) Non-payment related defaults;

(3) Unscheduled draws on debt service reserves reflecting financial difficulties;

(4) Unscheduled draws on credit enhancements reflecting financial difficulties;

(5) Substitution of credit or liquidity providers, or their failure to perform;

(6) Adverse tax opinions or events affecting the tax-exempt status of the security;

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Matters affecting collateral; and

(11) Rating changes.

(ii) Such written agreement or contract for the benefit of holders of such securities shall also specify:

(A) The accounting principles pursuant to which the audited financial statements will be prepared;

(B) The financial and pertinent operating information to be provided on an annual basis, in addition to audited financial statements; and

(C) The time within which the annual information for the preceding year will be provided to the repository.

(c) Recommendations without specified information. As a means reasonably designed to prevent fraudulent, deceptive, or

[42] 5 U.S.C. 604.

manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has reviewed the information the issuer of the municipal security has undertaken to provide pursuant to paragraph (b)(5) of this section.

(d) Exemptions. (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of $100,000 or more, if such securities:

(i) Are sold to no more than thirty five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less; or

(iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase 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.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as the issuer of municipal securities delivers the securities to the Participating Underwriters:

(i) The issuer will have less than $10,000,000 in aggregate amount of municipal securities outstanding, including the offered securities; and

(ii) The issuer will have issued less than $3,000,000 in aggregate amount, in the 48 months preceding the Offering.

(3) The provisions of paragraph (c) of this section shall not apply to a primary offering of municipal securities:

(i) Not sold in an Offering to which paragraph (b)(5) of this section applied; or

(ii) Sold in an Offering exempt under paragraph (d)(1) or paragraph (d)(2) of this section.

* * * * *

(f) Definitions. * * *

(3) The term final official statement means a document or set of documents prepared by the issuer of municipal securities or its representatives setting forth, among other matters, information concerning the terms of the proposed issue of securities, and financial and operating information adequate to provide a fair presentation of the issuer's and any significant obligor's current financial condition and results of operations, and cash flows, including audited financial statements, that is complete as of the date delivered to the Participating Underwriter.

* * * * *

(9) The term significant obligor means any person who, directly or indirectly, is the source of 20 percent or more of the cash flow servicing the obligations on the municipal securities.

(g) Transitional Provision. * * * Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before [effective date of final rule].

By the Commission.

Jonathan G. Katz
Secretary

Dated: March 9, 1994

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 240
Release No. 34-33743, File No. S7-6-94
RIN 3235-AF84; 3235-AG12
CONFIRMATION OF TRANSACTIONS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed Amendments to Rule 10b-10 and Proposed Rulemaking.

SUMMARY: The Securities and Exchange Commission is publishing for comment amendments to Rule 10b-10 and proposed Rule 15c2-13 under the Securities Exchange Act of 1934. The proposed amendments to Rule 10b-10 are designed to clarify the operation of the Rule, particularly in light of changes in the securities markets and the development of new securities products. The amendments and new rule are designed to enhance the disclosure given to customers so that customers can better evaluate their securities transactions. The Commission is seeking comment on the function of the confirmation in the context of a three day settlement period, and the adequacy and readability of customer periodic statements.

DATES: Comments should be received on or before June 15, 1994.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 6-9, Washington, D.C. 20549. Comment letters should refer to File No. S7-6-94. All comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Robert Colby, Deputy Director, (202/272-2790), Catherine McGuire, Chief Counsel,

(202/272-2844), or C. Dirk Peterson, Attorney, (202/504-2418), Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5-1, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

The Securities and Exchange Commission ("SEC" or "Commission") proposes to amend the confirmation requirements under Rule 10b-10[1] of the Securities Exchange Act of 1934 ("Exchange Act")[2] to strengthen its investor protection function. Generally, Rule 10b-10 requires a broker-dealer that effects transactions for customers in securities, other than U.S. Savings Bonds or municipal securities, to provide a written notification to the customer, at or before completion of the transaction, that discloses information about the transaction.[3] Confirmation of a securities transaction provides basic customer protection, the importance of which was recognized by the Commission as early as 1937.[4]

The proposed amendments to Rule 10b-10 would: (1) require confirmation disclosure of mark-ups and mark-downs for riskless principal transactions in debt securities; (2) require disclosure of the fact that a debt security is not rated by a nationally recognized statistical rating organization; (3) require confirmation disclosure of mark-ups and mark-downs in Nasdaq and exchange-listed securities; (4) require disclosure regarding whether broker-dealers are not members of the Securities Investor Protection Corporation; (5) modify the disclosure requirements with respect to certain collateralized debt securities; (6) add a preliminary note to the Rule indicating that the Rule's disclosure requirements do not limit disclosures necessary under the antifraud provisions of the federal securities laws; and (7) restructure the Rule.

Proposed Rule 15c2-13 would require brokers, dealers, and municipal securities dealers (1) to disclose mark-up information in riskless principal transactions in municipal securities; and (2) to disclose when a particular municipal security is not rated by a nationally recognized statistical rating organization.

The confirmation serves several functions: it acts as a customer invoice; informs investors of the details of a transaction, allowing the investor to check for errors or misunderstandings; provides consumer information, allowing investors to evaluate the cost and quality of the services provided by broker-dealers; discloses to investors possible conflicts of interest between them and the broker-dealer; and acts as a safeguard against fraud, by permitting the customer to detect problems associated with a transaction.

Implementation of a settlement period of three days ("T+3") may alter the confirmation's utility as a customer invoice because normal confirmation delivery and the transfer of customer funds and securities may not be possible within the three day settlement period. Under the previous settlement period of five days, confirmations generally reached customers in time for the customer to review them prior to transferring funds or securities to the transacting broker-dealer. Under T+3, the customer frequently will not receive the confirmation through the mails by day three;[5] thus, shortening the settlement period may require broker-dealers either to demand funds or securities from the customer earlier than at present or to cover the cost of the transaction for a longer period of time.

Although implementation of T+3 does not create compliance problems with regard to Rule 10b-10,[6] the Commission requests comment on its effect on the confirmation's investor protection functions. If the confirmation is used less frequently as an invoice, should some of the confirmation's content be shifted to periodic account statements?[7]

In this connection, the Commission solicits comment on the adequacy and readability of periodic statements of account generally and whether these account statements are read and relied upon by investors in monitoring their accounts.

[1] 17 CFR 240.10b-10.

[2] 15 U.S.C. §§78a *et seq.*

[3] A broker-dealer has an obligation under Rule 10b-10 to send its customers an immediate confirmation with respect to each transaction the broker-dealer effects. In the case of a customer account managed by a fiduciary of the customer, it is important to note that the account is the customer, rather than the fiduciary. *See generally Letter regarding Merrill Lynch, Broadcort Capital Corp. and Wagner Stott Clearing Corp.* (March 25, 1991) [available on LEXIS]. Accordingly, under Rule 10b-10, a broker-dealer must send an immediate confirmation to the account holder, in addition to any confirmation it may send to an account fiduciary. The Commission believes, however, that an account that has given discretionary authority in writing to its fiduciary may agree in writing with the broker-dealer effecting its trades to waive the receipt of an immediate confirmation required by Rule 10b-10 if (1) the broker-dealer sends an immediate confirmation to the account's fiduciary, and (2) a broker-dealer sends the discretionary account a statement no less frequently than quarterly containing all the information required to be disclosed on the immediate confirmation. The customer may not waive this quarterly statement.

[4] Rule 15c1-4, 17 CFR 240.15c1-4, an earlier confirmation rule, was adopted by the Commission in 1937. Securities Exchange Act Release No. 1330 (Aug. 4, 1937). This rule, which solely applied to transactions in securities in the over-the-counter market, was replaced in 1978 by Rule 10b-10, which extended the Commission's confirmation requirements to trades conducted on a securities exchange. Securities Exchange Act Release No. 15219 (Oct. 6, 1978), 43 FR 47495. Rule 10b-10 initially was adopted in part in May 1977. Securities Exchange Act Release No. 13508 (May 5, 1977), 42 FR 25318 ("Adopting Release").

[5] Broker-dealers may alleviate the concerns of mail delay, for example, by sending confirmations by facsimile.

[6] Some commentators suggested that substantive changes to Rule 10b-10 will be necessary as a result of the adoption of Rule 15c6-1 of the Exchange Act, 17 CFR 240.15c6-1, which implemented T+3. Because Rule 10b-10 requires a broker-dealer to send a customer written confirmation "at or before completion of the transaction," some have argued that a T+3 settlement period will make compliance with Rule 10b-10 impossible. The Commission notes, however, that broker-dealers can comply with Rule 10b-10 even under a T+3 settlement period. Rule 10b-10 requires only that the broker-dealer **send** written confirmation by settlement date, not that the customer actually **receive** it by settlement. In the current five days settlement period, broker-dealers typically send customer confirmations the day after trade date, which will satisfy Rule 10b-10 even under a T+3 settlement period.

[7] Six of the exchanges and the National Association of Securities Dealers, Inc. ("NASD") have rules requiring that such periodic statements be sent to customers. The Commission has proposed a rule requiring annual account statements in the payment for order flow context. *See* Securities Exchange Act Release No. 33026 (Oct. 7, 1993), 58 FR 52934 (Oct. 13, 1993).

I. DISCLOSURE OF MARK-UPS IN RISKLESS PRINCIPAL TRANSACTIONS IN DEBT SECURITIES

Rule 10b-10 currently requires disclosures of broker-dealer compensation in agency and specified principal trades. In agency trades, the confirmation must disclose both the transaction price and the commission charged.[8] In principal trades involving "Reported Securities,"[9] the confirmation must disclose the trade price reported by the broker-dealer for that transaction and the mark-up calculated from the reported price.[10] In "riskless" principal trades in non-reported equity securities,[11] Rule 10b-10 requires brokers and dealers, other than market makers, to disclose the amount of any mark-up received.[12] The Commission is proposing to amend Rule 10b-10 to require the disclosure of mark-up information for riskless principal trades in debt securities, other than U.S. Savings Bonds and municipal securities. The Commission also is proposing Rule 15c2-13 to require disclosure of mark-up information in riskless principal trades in municipal securities. Rule 10b-10 currently requires confirmations for transactions in debt securities to disclose to the customer the net dollar price and yield, but not separate disclosure of compensation information.[13] The Commission believes that investors in debt securities, like investors in equity securities, should be informed of the costs in riskless principal trades because, despite the legal distinctions, these trades are the functional equivalent of transactions effected on an agency basis.

On three previous occasions, the Commission proposed amendments to Rule 10b-10 that would have required disclosure of mark-ups for riskless principal trades involving debt securities, including municipal securities.[14] Commentators argued against adoption of mark-up disclosure for riskless principal debt trades saying that: (1) the amount of a mark-up was not material to investors; (2) adoption of the proposal would have a detrimental, disproportionate effect on small broker-dealers; and (3) the amendment would present compliance and enforcement difficulties because of differences between the debt and equity markets.[15] The Commission withdrew the proposal in 1982,[16] and subsequently adopted amendments requiring that confirmations contain disclosures concerning the yield of debt securities.[17]

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[8] 17 CFR 240.10b-10(a)(2) and 17 CFR 240.10b-10(a)(7)(ii).

[9] Rule 11Aa3-1(a)(4), 17 CFR 240.11Aa3-1(a)(4), defines "Reported Security" as any exchange-listed equity security or Nasdaq security for which transaction reports are made available on a real-time basis pursuant to an effective transaction reporting plan. An "effective transaction reporting plan" refers to a transaction reporting plan that the Commission has approved pursuant to Rule 11Aa3-1. 17 CFR 240.11Aa3-1(a)(3).
Reported Securities presently include:

1. Nasdaq securities that meet standards set forth in the National Market System Securities Designation Plan ("Nasdaq/NMS securities").
2. Certain securities listed on a national securities exchange that meet standards of the transaction reporting plan known as the Restated Consolidated Tape Association Plan ("CTA Plan"). This would include securities that are registered or admitted to unlisted trading privileges on a national securities exchange, including securities listed on various regional exchanges, and that substantially meet New York Stock Exchange, Inc ("NYSE") or American Stock Exchange, Inc. ("Amex") original listing criteria.

A number of securities that are quoted on Nasdaq and listed on certain regional stock exchanges, however, are not subject to an effective transaction reporting plan. Approximately 1,600 securities traded on Nasdaq do not satisfy the criteria for designation as a Nasdaq/NMS security, and thus are not part of an effective transaction reporting plan. Similarly, a limited number of regional-exchange listed securities are not covered by the CTA Plan.

[10] 17 CFR 240.10b-10(a)(8)(i)(B).

[11] "Riskless" principal trades are transactions in which, after receiving an order to buy or sell from a customer, the broker-dealer purchases the security from another person to offset a contemporaneous purchase by the customer or sells the security to another person to offset a contemporaneous sale by the customer. Although these transactions are characterized as riskless, they still involve counterparty risk. *See* Exchange Act Rule 15c3-1(a)(2)(vi), 17 CFR 240.15c3-1(a)(2)(vi), (relating to net capital requirements).
Rule 10b-10 currently does not require that a broker-dealer acting as a principal, other than in a "riskless" principal capacity, disclose the amount of mark-up for transactions in non-reported securities. *But see, infra* Section 3 for a discussion of mark-up disclosure requirements for non-reported securities that are subject to last-sale reporting.
For purposes of clarity and to conform to Rule 15g-4, 17 CFR 240.15g-4 (requiring riskless principal disclosure for trades involving penny stocks), the Commission proposes to replace the term "amount of any mark-up, mark-down, or similar remuneration received," currently used in Rule 10b-10, with "difference between the price to the customer and such contemporaneous purchase or sale price."

[12] 17 CFR 240.10b-10(a)(8)(i)(A). For purposes of this release, references to mark-ups are equally applicable to mark-downs or commission equivalents. In determining the broker-dealer's mark-ups for antifraud disclosure purposes, the Commission advises broker-dealers to note that the framework set forth in Alstead, Dempsey & Company, Inc., 47 S.E.C. 1034 (1984), governs the appropriate method for determining the prevailing market price in active or dominated and controlled markets. *See* Securities Exchange Act Release No. 29093 (Apr. 17, 1991), 56 FR 19165, for further discussion of *Alstead* in connection with proposed penny stock rules which are adopted in Securities Exchange Act Release No. 30608 (Apr. 20, 1992), 57 FR 18004. *See also* Meyer Blinder, Securities Exchange Act Release No. 31095, (Aug. 26, 1992), 52 SEC Doc. 1436, *appeal docketed sub. nom.* Gorden v. SEC, No. 92-1554 (D.C. Cir.) appeal dismissed per stipulation (applying the *Alstead* framework to case involving excessive mark-ups in a dominated and controlled market). *See* Securities Exchange Act Release No. 33083 (Oct. 21, 1993).

[13] 17 CFR 240.10b-10(a)(5).

[14] *See* Securities Exchange Act Release No. 15220 (Oct. 6, 1978), 43 FR 47538 (proposing mark-up disclosure for riskless principal trades in municipal securities) ("1978 Release"); Securities Exchange Act Release No. 13661 (June 23, 1977), 42 FR 33348 (proposing mark-up disclosure by non-market makers in riskless principal transactions involving equity and debt securities, but not municipal securities); and Securities Exchange Act Release No. 12806 (Sept. 16, 1976), 41 FR 41432 (proposing mark-up disclosure by non-market makers in riskless principal transactions involving equity and debt securities).

[15] One commentator noted that determining whether a particular firm was a market maker in the debt context was difficult because the market maker definition contemplates an equity environment and does not account for the differences in the debt environment. *See* Letter from Sullivan & Cromwell, to George A. Fitzsimmons, Secretary, SEC, dated January 15, 1979.

[16] Securities Exchange Act Release No. 18987 (Aug. 20, 1982), 47 FR 37919.

[17] Securities Exchange Act Release No. 18988 (Aug. 20, 1982), 47 FR 37920, *adopted in* Securities Exchange Act Release No. 19687 (Apr. 18, 1983), 48 FR 17583.

In light of the increasing size of the debt market,[18] together with experience with mark-up disclosure in riskless principal trades for equities, the Commission believes that mark-up disclosure for riskless principal trades in debt securities should be revisited.[19] Confirmation disclosure of mark-ups in riskless principal transactions will aid investors by disclosing to them transaction costs. This will assist the client in monitoring brokerage expenses and detecting possible improper practices. For instance, the Commission understands that mark-ups charged in riskless principal trades in long-term securities are substantially greater than mark-ups charged in short-term securities, because the impact on disclosed yield is smaller in the long term trade. The Commission believes that customers should be given the ability to compare mark-ups in these trades.

In withdrawing the riskless principal mark-up disclosure proposal in the 1978 Release, the Commission stated that it would "maintain close scrutiny to prevent excessive mark-ups and take enforcement action where appropriate."[20] Since 1982, the Commission and NASD have undertaken a number of enforcement actions against broker-dealers involving undisclosed, excessive mark-ups in debt securities.[21] Requiring disclosure of mark-ups in riskless principal trades in debt securities would supplement the Commission's and self-regulatory organizations' enforcement programs, by giving investors greater ability to review the mark-ups on their transactions. As a practical matter, the proposed amendment also may permit broker-dealers that consistently observe the highest standards of practice to compete more effectively against broker-dealers that charge excessive mark-ups.[22]

Because riskless principal transactions do not involve holding securities in inventory for any appreciable length of time,[23] the broker-dealer's compensation easily can be calculated by comparing the order tickets for the purchase and sale involved. In addition, a broker-dealer must assess whether its mark-ups violate NASD or Commission mark-up policies. Accordingly, the Commission does not believe that the proposal would be overly burdensome for broker-dealers.

Unlike current disclosure requirements for riskless principal transactions in equity securities, the proposed amendment and Rule 15c2-13 do not include an exclusion for market makers. This exclusion is omitted because market makers have a much more limited function in the debt markets. Typically, dealers in these markets, especially the municipal market, do not display two-sided quotations nor carry inventories of debt securities, as is characteristic of a market maker in equity securities. Because of the tax

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[18] The amount of outstanding debt in the U.S. is approximately $1.9 trillion in corporate debt, of which $298 billion is held by individual investors (households and mutual funds) in corporate and foreign debt securities (*See* Flow of Fund Accounts, First Quarter, 1993), $4.9 trillion in U.S. government securities, and $1.2 trillion in municipal bonds. Securities Industry Fact Book, Securities Industry Association (1993), at 21. The municipal securities market comprises approximately 50,000 state and local issuers with an outstanding principal amount of securities in excess of $1.2 trillion. *See* SEC Report on the Municipal Securities Market (Sept. 1993), at 1. There are approximately 1.3 million classes of municipal securities spread across 150,000 different issuances. Public Securities Association.

[19] Mark-up disclosure requirements are applicable at present to trades in debt securities convertible into equity securities. Section 3(a)(11), 15 U.S.C. § 78c(a)(11), and Rule 3a11-1 of the Exchange Act, 17 CFR 240.3a11-1, define equity security to include any security convertible into an equity security. Debt security is defined to include a convertible security for purposes of certain paragraphs of Rule 10b-10, but not for purposes of mark-up disclosure in riskless principal trades.

[20] Securities Exchange Release No. 18987 (Aug. 20, 1982), 47 FR 37919, at 37920.

[21] *See, e.g.*, F.B. Horner & Associates v. S.E.C., 994 F.2d 61 (2d Cir. 1993) (mark-ups charged of 5% for collateralized mortgage obligations held to be excessive); First Honolulu Securities Corp., mark-ups of 5% for municipal and corporate bonds held to be excessive); Investment Planning, Inc., Securities Exchange Act Release No. 32687 (July 28, 1993) (upholding NASD finding that mark-ups of 4% on certain corporate and municipal bonds were excessive); Lake Securities, Inc., (Securities Exchange Act Release No. 31283 (Oct. 2, 1992) (mark-down of 7.4% on FNMA mortgage-backed securities held to be fraudulent); Hamilton Bohner, 44 S.E.C. Doc. 1297 (1989) (mark-downs ranging from 5.3% to 10.2% in excess of permissible levels and NASD's findings of violations upheld); Donald T. Sheldon, Admin. Proc. File No. 3-6626 (December 2, 1988)[available on LEXIS](undisclosed mark-ups of over 8% for municipal bonds and over 5% for government securities found to be excessive), appeal docketed, No. 93-4405 (11th Cir.); Alan Charles Refkin, Securities Exchange Act Release No. 26311 (Nov. 25, 1988), 42 S.E.C. Doc. 490 (consent decree included findings that certain registered representatives executed transactions involving mark-ups of between 10% and 34% in zero coupon bonds); PaineWebber, Inc., Securities Exchange Act Release No. 25418 (Mar. 4, 1988), 40 S.E.C. Doc. 693 (offer of settlement stated that registrant charged customers undisclosed, excessive mark-ups in transactions involving the sale and repurchase of stripped U.S. Treasury bond coupons); Nicholas A. Codispoti, 48 S.E.C. 842 (1987) (mark-ups of 6.1% to 32.7% on municipal bonds with inactive market found to be excessive); Sutro & Co., Securities Exchange Act Release No. 23663 (Sept. 30, 1986), 36 S.E.C. Docket 1199 (offer of settlement included finding that transactions were executed with mark-ups and mark-downs of between 10% and 34% on U.S. Treasury bonds); Hanauer, Stern & Co., Securities Exchange Act Release No. 21313 (Sept. 11, 1984), 31 S.E.C. Doc. 483 (consent decree included findings of excessive mark-ups on municipal securities transactions); S.E.C. v. MV Securities, Inc. (S.D.N.Y., No. Civ. 1164), Litigation Release No. 10289 (Feb. 21, 1984), 29 S.E.C. Doc. 1591, (defendants enjoined from, *inter alia*, paying or charging unfair prices to customers in municipal bond transactions).
The Commission brought an injunctive action against an unregistered broker-dealer for defrauding his customers by secretly interpositioning himself between customers and dealers in certain government and municipal securities, and appropriating for himself better market prices that should have been made available to his customers. SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990).
In addition, the Commission has submitted amicus briefs in cases alleging excessive mark-ups in debt securities. *See, e.g.*, *Amicus Curiae* Brief of the SEC and Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D. N.J. 1989)(brief arguing that mark-ups ranging from 17.4% to 21.27% for principal only trust certificates were excessive and mark-ups ranging between 5.3% to 7.39% on collateral mortgage obligations were excessive).

[22] The Commission is aware of instances in which the customer, while being correctly informed that no "commission" is involved in a principal transaction in a debt security, has been given the impression that no transaction fee is being charged. *See* "Firms Must Accurately Disclose Bond Trading Charges," *NASD Regulatory & Compliance Alert* (June 1990). Irrespective of current or future Rule 10b-10 disclosure requirements, a misleading statement or a failure to disclose material facts about the compensation received by the broker-dealer constitutes an antifraud violation.

[23] The riskless principal disclosure requirements are intended to apply to offsetting transactions, regardless of the sequencing of the transaction. *See* Securities Exchange Act Release No. 15219 (Oct. 6, 1978), at n. 20; and *Letter regarding Buys-MacGregor, McNaughton-Greenwalt & Co.*, (Feb. 1, 1980), [1980] Fed. Sec. L. Rep. (CCH) ¶76,313.

implications, the lack of dealer inventory, and the relative illiquidity of the market for any particular municipal security, short positioning of municipal securities is difficult and imposes greater risk that a dealer will be unable to cover its short position.[24]

The Commission requests comment on the proposal to disclose mark-ups in riskless principal transactions in debt securities. In particular, the Commission requests comment concerning whether proposals requiring mark-up disclosure in riskless principal transactions in municipal securities should be incorporated in one rule under the authority of the Municipal Securities Rulemaking Board ("MSRB"), rather than the Commission. In addition, comment is sought concerning the proposed definition of riskless principal contained in sub-paragraphs (e)(10) and (b)(3) of Rule 10b-10 and Rule 15c2-13, respectively.[25] The Commission further requests comment concerning the extent to which broker-dealers act as market makers, as defined in Section 3(a)(38), in the debt market and the extent that broker-dealers currently calculate mark-ups in riskless principal debt transactions for business purposes, such as determining the compensation of sales personnel.[26] In addition, the Commission requests comment on whether the proposed requirements for mark-up disclosure in debt securities should cover securities transactions occurring on the same day rather than limiting the disclosure solely to riskless principal transactions.

II. DISCLOSURE OF UNRATED DEBT SECURITIES

As proposed, both Rule 10b-10 and Rule 15c2-13 will require broker-dealers to disclose when a debt security, other than securities defined under Section 3(a)(42)(A) and (B) of the Exchange Act,[27] is not rated by a nationally recognized statistical rating organization. The Commission is not requiring the disclosure of the specific rating of a debt security because that information most likely will be disclosed to a customer when a broker-dealer sells such a security. Brokers are less likely to inform customers that a security is not rated. While the Commission recognizes that an unrated bond may not necessarily be unsound or speculative, this information will benefit investors by alerting them that they may want to make further inquiry of the broker-dealer. In the municipal securities market, this information is particularly useful because of the limited secondary market information in that market and the comparatively higher rates of issuer default for unrated municipal bonds.[28] The Commission requests comment whether securities other than U.S. Treasury securities should be excluded from this requirement. In addition, the Commission requests comment on whether this requirement as it relates to municipal securities should be incorporated in one rule under the authority of the MSRB.

III. DISCLOSURE OF MARK-UPS AND MARK-DOWNS IN CERTAIN NASDAQ AND EXCHANGE-LISTED SECURITIES

Since 1985, Rule 10b-10 has required broker-dealers acting as principals in transactions in Reported Securities[29] to disclose on customer confirmations the reported trade price, the price to the customer, and the difference between the two prices.[30] In response to the expansion of last sale reporting to additional securities, the Commission is now proposing to amend Rule 10b-10 to require similar disclosure in principal transactions in Nasdaq equity securities that are not Nasdaq/NMS securities ("Nasdaq Small Cap Securities") and certain exchange-listed securities. These securities are subject to last sale reporting, but are not included in the definition of "Reported Security," as provided in Rule 11Aa3-1 of the Exchange Act.

In April, 1992, the Commission approved a proposal by the NASD[31] to require last sale and volume reporting for all securities traded on Nasdaq.[32] Shortly afterwards, the NASD required its members to disclose to customers on written confirmations the reported trade price, the price to the customer, and the difference between the two prices in a particular Nasdaq Small Cap Securities transaction.[33] The NASD's rule provides customers who trade Nasdaq Small Cap Securities with the same compensation disclosure required under Rule 10b-10 for Nasdaq/NMS securities.

The proposed amendment would consolidate in Rule 10b-10 compensation disclosure applicable to all Nasdaq stocks. It also would extend this compensation disclosure to principal transactions in regional-exchange listed securities subject to last sale reporting.[34] Doing so would treat similar securities consistently and would provide benefits to customers with little additional burden on broker-dealers. Because securities traded through Nasdaq and regional exchanges are subject to last sale reporting requirements, and NASD members are required to disclose on confirmations the reported price, the customer's price, and the

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[24] Short positioning municipal securities is rare because the Internal Revenue Service will not allow both a borrower and lender of a municipal security to claim a tax exemption. In effect, the lender of a municipal security would be trading tax exempt interest for taxable interest. In addition, to the extent that any short positioning occurs with respect to municipal securities, the IRS imposes additional reporting requirements on the participating parties. *See* Internal Revenue Code, § 6045(d).

[25] *See, supra*, note 10 for a discussion of riskless principal transactions.

[26] Salesperson compensation is often determined as a percentage of the gross mark-up charged on a principal transaction.

[27] 15 U.S.C. § 78(c)(a)(42)(A) and (B).

[28] Statistics have shown that unrated municipal bonds, which make up approximately one-third of the market, in the aggregate have a higher default rate than do rated bonds. *See Municipal Bond Defaults--The 1980's a Decade in Review* 1-2, at 1, J.J. Kenny Co., Inc. 1993). According to this study on default rates between January 1, 1980 to December 31, 1991, 628 unrated issues defaulted compared with 98 rated issues. *See also*, Public Securities Association, *An Examination of Non-Rated Municipal Defaults 1986-1991* 4 (Jan. 8, 1993).

[29] *See, supra* note 8 for the definition of "Reported Securities."

[30] 17 CFR 240.10b-10(a)(8)(i)(B). The reported trade price is the price at which a broker-dealer reports a trade to NASDAQ or an exchange. Price to the customer means the ultimate price the customer pays or receives for a securities transaction, including any miscellaneous fees imposed by the broker-dealer. This would not include fees, such as taxes, SEC fees, or any other fees required by state or federal law. *See, e.g., Letter regarding Cities Securities Corp.* (Dec. 11, 1991) [available on LEXIS].

[31] Securities Exchange Act Release No. 30392 (Feb. 21, 1992), 57 FR 6880.

[32] Securities Exchange Act Release No. 30569 (Apr. 10, 1992), 57 FR 13396.

[33] NASD Schedule to By-Laws, Schedule D, pt. XI, § 3, NASD Manual (CCH) ¶1867D, *approved in* Securities Exchange Act Release No. 30871 (June 29, 1992), 57 FR 30281.

[34] Typically, these are securities of smaller companies that are listed and traded exclusively on one regional exchange.

difference, capturing and disclosing the same information for purposes of complying with Rule 10b-10 would not appear to require systems changes or additional personnel.

IV. DISCLOSURE OF COVERAGE BY THE SECURITIES INVESTOR PROTECTION CORPORATION

The Commission is proposing to require that the confirmation contain a disclosure concerning coverage under the Securities Investor Protection Act of 1970 ("SIPA").[35] Under SIPA, all brokers or dealers registered with the Commission under Section 15(b) of the Exchange Act, with certain exceptions,[36] are members of the Securities Investor Protection Corporation ("SIPC"). In the event of the financial failure of a SIPC member broker-dealer, SIPC protects each customer up to $500,000 for claims for cash and securities, except that claims for cash are limited to $100,000.

A number of incidents involving the financial failure of registered broker-dealers, and their unregistered affiliates, have illustrated the potential for confusion about the application of SIPC coverage to customers' accounts. In one of these cases, a registered broker-dealer and its government securities affiliate were commonly owned, shared personnel and office facilities, and did not distinguish between the two entities in certain written and oral communications, leading to customer confusion concerning SIPC coverage.[37] Because government securities brokers and dealers registered under Section 15C of the Exchange Act are not members of SIPC, their customer accounts are not protected by SIPC.[38]

In order to reduce the potential for confusion regarding whether SIPC coverage exists for accounts with government securities dealers, as well as other cases where an investor might mistakenly assume that SIPC coverage exists, the Commission is proposing to amend Rule 10b-10 to require broker-dealers that are not SIPC members to affirmatively state in the customer confirmation that they are not SIPC members and to require disclosure if the account is carried by a broker or a dealer that is not a SIPC member. This disclosure requirement would be consistent with the authority granted to the Commission concerning SIPC disclosure under the Government Securities Acts Amendments of 1993.[39]

V. DISCLOSURE FOR CERTAIN ASSET-BACKED SECURITIES

The Commission is proposing to amend the yield disclosure requirements with respect to asset-backed securities. The Rule currently requires broker-dealers that effect transactions in debt securities, other than U.S. Savings Bonds or municipal securities, to disclose (1) the yield to maturity, if the transaction is effected on the basis of dollar price; (2) if the transaction is effected on a yield basis, then the dollar price calculated from that yield; and (3) if effected on a basis other than dollar price or yield to maturity, and the yield to maturity will be less than the represented yield, then both the yield to maturity and represented yield.

When these amendments were adopted, the Commission noted the importance of yield data to an investor in transactions in debt securities.[40] The yield, or dollar price, at which a transaction is effected in the secondary market will be directly related to the anticipated maturity. Thus, features that cause a debt security to pay sooner or later than expected will alter the actual yield that an investor receives.

In recognition of this effect, the Commission excluded from the actual yield disclosure requirements securities that represent an interest in notes secured by liens upon real estate continuously subject to prepayment.[41] The Commission noted that fluctuations in interest rates may cause mortgage notes underlying participation certificates to prepay at rates faster or slower than anticipated. At the time the Commission adopted the yield amendments, the primary application of the exception was to transactions in securities issued or guaranteed by the Government National Mortgage Association, Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation.

Since 1983, when the yield disclosure provisions were added to the rule, the "structured financing"[42] market has been dramatically increased to include securities backed by mortgage notes, automobile loans, computer leases, consumer debt, and other receivables. Also, broker-dealers now offer a variety of derivative mortgage instruments and structured financing vehicles in which payment to investors is related directly to payments of principal and interest on underlying debt instruments. In many cases, these various asset-based securities subject the investor to the same prepayment risks that are present in mortgage participation certificates. To reduce prepayment exposure from asset backed securities for some investors, collateralized mortgage obligations ("CMOs") have been developed.

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[35] Securities Investor Protection Act of 1970. Pub. L. 91-598, 64 Stat. 1836, as amended (codified at 15 U.S.C. §§ 78aaa *et seq.*).

[36] The following broker-dealers are excluded from SIPC membership: (1) government securities broker-dealers registered under Section 15C of the Exchange Act; (2) persons whose principal business in the determination of SIPC (and subject to Commission approval) is conducted outside the United States; and (3) persons whose business consists exclusively of (a) the distribution of shares of registered open-end investment companies or unit investment trusts, (b) the sale of variable annuities, (c) the business of insurance, or (d) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts. SIPA §§ 3(a)(2)(A) and 16(12) 15 U.S.C. §§ 78ccc(a)(2)(A) and 78lll(12).

[37] *See generally*, SEC v. Donald Sheldon Group, Inc. et al., Admin. Pro. File No. 3-6626 (Dec. 2, 1988).

[38] *See*, *supra* note 33.

[39] 15 U.S.C. 78O-5(a)(4).

[40] Securities Exchange Act Release No. 19687 (April 18, 1983), 49 FR 17583.

[41] For purposes of paragraphs (a)(3) and (a)(4), the term "debt security" is defined in Rule 10b-10(e)(4), 17 CFR 240.10b-10(e)(4), to include a fractional or participation interest in notes. The Commission also excepted securities with a maturity date that may be extended by the issuer.

[42] "Structured financing" is a financing technique whereby a sponsor, which has originated or has purchased certain financial collateral, such as accounts receivable or mortgage loans, transfers such assets to a trust, a limited purpose entity organized solely for purposes of the offering. That entity then issues debt obligations or equity securities with debt-like characteristics. The process also has been termed "securitization."

CMOs are collateralized by pools of residential mortgage loans. Like other asset-backed securities, the rate of prepayment on the underlying collateral of CMOs is correlated inversely with interest rate changes in the general economy. The actual maturities of CMOs are dependent on these prepayment speeds. CMOs are priced on the basis of the estimated "weighted average life" ("WAL") of individual CMO tranches. As interest rates decline, prepayments increase, with a corresponding shortening of WALs. Conversely, an increase in interest rates results in a lengthening of maturity. Estimated yields cannot be established without some prepayment assumption underlying the WAL; for this reason, disclosure of accurate prepayment assumptions, and an appreciation of their implications, is essential to making a sound investment decision.

CMOs are offered in several tranches of varying maturity and yield that are intended to appeal to a broad spectrum of investors. One or more tranches typically are structured as a planned amortization class ("PAC"). PAC bonds, whose maturities are shielded from both WAL extension and contraction risk, have the maximum protection available in CMOs. Unlike PAC bonds, target amortization class ("TAC") bonds only provide protection against rapid prepayments, *i.e.*, against a shortening of maturity. In CMO offerings there also are "support classes," or "companion classes," of the PAC or TAC bond classes, which bear a disproportionate share of prepayment risk.[43]

In view of the changes in the structured financing market described above, the Commission proposes to revise the yield disclosure requirements for asset backed securities. On the one hand, the Commission proposes to expand the range of debt securities where yield need not be disclosed to include any asset backed security subject to continuous prepayment.[44] Broker-dealers must disclose yield information with respect to debt instruments that are insulated from prepayment risk, or where sufficient certainty exists to permit an accurate forecast of the yield that investors will receive.[45]

On the other hand, the Commission proposes to treat CMOs differently from other debt instruments under the proposed amendments. A broker-dealer effecting transactions in CMOs would be required to disclose, with respect to the security, (1) estimated yield, (2) the weighted average life, and (3) the prepayment assumptions underlying the yield.

The Commission emphasizes that the proposed amendments only would apply to yield disclosure on a confirmation and would not affect the broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose material information, apart from that required by Rule 10b-10, regarding the composition of mortgage pools or other factors that will affect yield.

In this connection, the Commission requests comments concerning the manner in which yields are represented to investors in mortgage-backed securities; the assumptions made by broker-dealers concerning prepayment speed for mortgage pools; and how interest rate risk and foreclosure risk are disclosed to investors in mortgage-backed securities.

The Commission requests comment on the effect of the amendments on customer understanding of the return on their investments. In addition, the Commission requests comment on the advisability of requiring separate disclosure relating to the prepayment assumptions underlying a yield quotation in a CMO and on the written confirmation for a transaction in a CMO.

IV. PRELIMINARY NOTE TO RULE 10b-10

The Commission proposes to add a preliminary note to Rule 10b-10 to clarify the relationship between the Rule's disclosure requirements and additional disclosures that may be required to satisfy antifraud provisions of the federal securities laws. In several cases over the years, broker-dealer defendants have argued that because Rule 10b-10 did not require disclosure of specific information on a confirmation, it was not material for purposes of the general antifraud provisions of the Exchange Act.[46] Although courts have given short shrift to these arguments, the Commission wishes to reiterate that Rule 10b-10 is not a safe harbor from the general antifraud provisions of the federal securities laws.[47] A broker-dealer has a duty established by federal common law

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[43] The PAC bond's cash flow stability is achieved by giving its principal payments a higher priority than those of the CMO "companion" tranches. While PAC bonds generally yield about 50 to 75 basis points above comparable Treasury bonds, companion tranches can yield as much as 150 to 175 basis points above comparable Treasury bonds, an attractive yield for investors seeking alternatives to money market funds and certificates of deposit. As a by-product of PAC or TAC bonds, however, "companion" bonds are more volatile than PAC or TAC bonds. According to Fitch Investors Service, Inc., "companion" bonds generally demonstrate "moderate-to-high volatility, with a very small percentage having low volatility." "CMO Tranche Risk Revealed," Fitch Investors Service, Inc. 3 (April 6, 1992).

[44] This amendment would codify a no-action response issued by the staff in 1988 with respect to mortgage-backed securities, and apply it to asset-backed securities generally. *Letter regarding Merrill Lynch Capital Markets* (Oct. 19, 1988) [available on LEXIS].

[45] For example, the Commission notes that mortgage loans on multi-family housing may contain substantial prepayment penalties, so that a security collateralized by or representing an interest in such notes would be expected to provide a predictable payment stream to investors. Similarly, automobile receivables may provide a predictable payment stream because automobile owners are less likely to prepay their automobile loans. By their nature, certain securities, such as most mortgage-backed bonds, also provide certainty of cash flow.

[46] *See, e.g.*, Shivangi v. Dean Witter Reynolds, Inc., 637 F. Supp. 1001 (S.D. Miss. 1986), *aff'd*, 825 F.2d 885 (5th Cir. 1987); Krome v. Merrill Lynch, Pierce, Fenner & Smith Inc., 637 F. Supp. 910, 915-916 (S.D.N.Y. 1986); and Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Fed. Sec. L. Rep. (CCH) ¶93,102 (E.D. Pa. 1986), *rev'd*, 835 F.2d 1031 (3d Cir. 1987).

[47] In the adopting release to Rule 10b-10, the Commission explained that:

> The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities. Rule 10b-10 only mandates the disclosure of information which can generally be expected to be material. Of course, in particular circumstances, additional information may be material and disclosure may be required.

Securities Exchange Release No. 13508, (May 5, 1977), 42 FR 25318, at 25320 n.28.

See also Securities Exchange Act Release No. 22397 (Sept. 11, 1985), 50 FR 37648, 37653 n.53 (indicating that disclosure of a "mark-up" for national market system securities under Rule 10b-10 would not control traditional determinations of, among other things, whether the mark-ups are excessive for purposes of the antifraud provisions of the federal securities laws).

theories[48] independent of the requirements of Rule 10b-10 to disclose material facts to an investor at the time of the investor's investment decision.[49]

In amending Rule 10b-10, the Commission must balance the increased cost to broker-dealers, and ultimately to investors, of compliance against the benefits that added disclosures will provide investors.[50] In some instances, the Commission has declined to adopt proposed amendments to its confirmation requirements because they were considered too costly, or would have been too difficult to apply on a uniform basis.[51] Even when the Commission has not required broker-dealers to disclose specific information to investors pursuant to Rule 10b-10, this information nonetheless may be material to an investor.[52]

Accordingly, the Commission is proposing to add a brief preliminary note to the Rule, expressing the long-standing position that Rule 10b-10 was not intended to codify the universe of disclosure necessary in a transaction.

VII. RESTRUCTURING OF THE RULE

A variety of non-substantive changes have been made to the rule to enhance its clarity. Headings have been added to each paragraph. Paragraph (a) has been reordered to combine elements dependent on the capacity of the broker or dealer. Paragraphs (b) and (c) have been combined into a single paragraph (c), and one element of former paragraph (b) has been moved to the definition of "investment company plan" in paragraph (e). A definition of riskless principal transaction has been added, and references to broker or dealer have been made gender neutral.

VIII. EFFECTS ON COMPETITION AND REGULATORY FLEXIBILITY ACT CONSIDERATIONS

Section 23(a)(2) of the Exchange Act[53] requires that the Commission, in adopting rules under the Act, consider the anti-competitive effects of such rules, if any, and balance any anti-competitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission is preliminarily of the view that the proposed amendments to Rule 10b-10 will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment, however, on any competitive burdens that might result from adoption of the amendments or the new rule.

In addition, the Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), pursuant to the requirements of the Regulatory Flexibility Act,[54] regarding the proposed amendments to Rule 10b-10. The IRFA may be obtained from C. Dirk Peterson, in the Office of Chief Counsel, Division of Market Regulation, (202) 504-2418.

In addition, the Commission has consulted with the Department of Treasury pursuant to Section 15(c)(2) of the Exchange Act concerning the SIPC disclosure requirements.

LIST OF SUBJECTS IN 17 CFR PART 240

Reporting and recordkeeping requirements, securities

TEXT OF PROPOSED AMENDMENTS

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78o-5, 78p, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

[48] Two theories, the fiduciary and shingle theory, establish an obligation on the part of a broker-dealer to deal with customers fairly. In cases where a broker-dealer has established a customer relationship based upon trust and confidence, and the customer depends upon and follows the broker-dealer's advice, a fiduciary relationship is established between the broker-dealer and customer. As a fiduciary, the broker-dealer also is obligated to disclose all the material facts of a customer's transaction. *See* In re Arleen W. Hughes, 27 S.E.C. 627 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949).

Closely related to the fiduciary theory is a duty to the customer established by the "shingle theory." According to the shingle theory, a broker-dealer impliedly represents at the outset of a securities transaction that it will deal with its customers fairly and in accordance with the standards of the industry. Duker & Duker, 6 S.E.C. 386, 388-89 (1939).

[49] The fact that a broker-dealer has met the requirements of Rule 10b-10 should begin the analysis, not end it. The confirmation is delivered after the contract is created. Thus, irrespective of the content of the confirmation, specific terms of the transaction that may affect the customer's investment decision should be disclosed at the time of a purchase or sale of a security. *See, e.g.*, Norris & Hirshberg v. S.E.C., 177 F.2d 228 (D.C. Cir. 1949) (affirming a Commission decision holding that the failure of a broker-dealer to disclose its true capacity at the time of a transaction, as principal rather than as agent, was, among other things, a violation of Section 10(b) of the Exchange Act, notwithstanding the fact that the broker-dealer had disclosed that it was acting as principal in confirmations sent to investors).

[50] For example, the Commission noted in the release proposing Rule 10b-10 that:

> Since the costs of regulation designed to promote investor protection are in the final analysis paid for in large part by the investor, the Commission is endeavoring to adjust regulatory requirements to eliminate those for which compliance costs appear to be disproportionate to the practical benefits of investor protection thereby obtained.

Securities Exchange Act Release No. 12806 (Sept. 16, 1976), 41 FR 41432.

[51] *See* Securities Exchange Act Release No. 18987 (Aug. 20, 1982), 47 FR 37919.

[52] The Commission reiterated this point in a release concerning disclosure of mark-ups in zero-coupon instruments. Securities Exchange Act Release No. 24368 (Apr. 21, 1987), 52 FR 15575. *See also Amicus Curiae* Brief of the SEC and Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031 (3d Cir. 1987).

[53] 15 U.S.C. § 78w(a)(2).

[54] 5 U.S.C. § 603.

2. Section 240.10b-10 is amended by adding a preliminary note prior to paragraph (a), revising paragraphs (a) and (b), removing paragraph (c), redesignating paragraphs (d) through (f) as paragraphs (c) through (e), revising the introductory text of newly designated paragraph (d)(6) and adding paragraphs (d)(9) and (d)(10) to read as follows:

§ 240.10b-10 Confirmation of transactions.

Preliminary Note. This section requires broker-dealers to disclose specified information in writing to customers at or before the completion of a transaction. The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision.

(a) Disclosure Requirement. It shall be unlawful for any broker or dealer to effect for or with the account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security (other than U.S. Savings Bonds or municipal securities) unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing:

(1) The date and time of the transaction (or the fact that the time of the transaction will be furnished upon written request of such customer) and the identity, price, and number of shares or units (or principal amount) of such security purchased or sold by such customer; and

(2) Whether the broker or dealer is acting as agent for such customer, as agent for some other person, as agent for both such customer and some other person, or as principal for its own account; and if the broker or dealer is acting as principal, whether it is a market maker in the security (other than by reason of acting as a block positioner); and

(i) If the broker or dealer is acting as agent for such customer, for some other person, or for both such customer and some other person:

(A) The name of the person from whom the security was purchased, or to whom it was sold, for such customer or the fact that such information will be furnished upon written request of such customer; and

(B) The amount of any remuneration received or to be received by the broker from such customer in connection with the transaction unless remuneration paid by such customer is determined, pursuant to a written agreement with such customer, otherwise than on a transaction basis; and

(C) The source and amount of any other remuneration received or to be received by the broker in connection with the transaction: Provided, however, That if, in the case of a purchase, the broker was not participating in a distribution, or in the case of a sale, was not participating in a tender offer, the written notification may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer; or

(ii) If the broker or dealer is acting as principal for its own account:

(A) In the case of a riskless principal transaction, except where the dealer is a market maker in an equity security, the difference between the price to the customer and the dealer's contemporaneous purchase (for customer purchases) or sale price (for customer sales); or

(B) In the case of any other transaction in a reported security, or an equity security that is quoted on Nasdaq or traded on a national securities exchange, and that is subject to last sale reporting, the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer.

(3) Whether any odd-lot differential or equivalent fee has been paid by such customer in connection with the execution of an order for an odd-lot number of shares or units (or principal amount) of a security and that the amount of any such differential or fee will be furnished upon oral or written request: Provided, however, That such disclosure need not be made if the differential or fee is included in the remuneration disclosure, or exempted from disclosure, pursuant to paragraph (a)(2)(ii)(B) of this section; and

(4) In the case of any transaction in a debt security subject to redemption before maturity, a statement to the effect that such debt security may be redeemed in whole or in part before maturity, that such a redemption could affect the yield represented and that additional information is available upon request; and

(5) In the case of a transaction in a debt security effected exclusively on the basis of a dollar price:

(i) The dollar price at which the transaction was effected, and

(ii) The yield to maturity calculated from the dollar price; provided, however, that this paragraph (a)(5)(ii) shall not apply to a transaction in a debt security that either:

(A) Has a maturity date that may be extended by the issuer thereof; or

(B)(1) That represents an interest in, or is secured by, notes or other receivables continuously subject to prepayment, where payments to security holders are reasonably related to payments on such notes or receivables; and

(2) The written statement prominently indicates that the actual yield received by the customer may vary according to the rate at which the underlying notes or receivables are prepaid; and

(6) In the case of a transaction in a debt security effected on the basis of yield

(i) The yield at which the transaction was effected, including the percentage amount and its characterization (e.g., current yield, yield to maturity, or yield to call) and if effected at yield to call, the type of call, the call date and call price;

(ii) The dollar price calculated from the yield at which the transaction was effected; and

(iii) If effected on a basis other than yield to maturity and the yield to maturity is lower than the represented yield, the yield to maturity as well as the represented yield: Provided, however, that this paragraph (a)(6)(iii) shall not apply to a transaction

in a debt security which either:

(A) Has a maturity date that may be extended by the issuer thereof, with a variable interest rate payable thereon; or

(B)(1) That represents an interest in, or is secured by notes or other receivables continuously subject to prepayment, where payments to security holders are reasonably related to payments on such notes or receivables; and

(2) The written statement prominently indicates that the actual yield received by the customer may vary according to the rate at which underlying notes or receivables are prepaid; and

(7) In the case of a debt security that is a collateralized mortgage obligation, the yield to maturity calculated on the basis of the "weighted average life" of the security; the weighted average life; and the prepayment assumption underlying this yield; and

(8) In the case of a transaction in a debt security, other than a security defined under Section 3(a)(42)(A) and (B) of this Act (15 U.S.C. 78(c)(a)(42)(A) and (B), that the security is unrated by a nationally recognized statistical rating organization, if such is the case; and

(9) That the broker or dealer is not a member of the Securities Investor Protection Corporation, or that the broker or dealer clearing or carrying the customer account is not a member of the Securities Investor Protection Corporation, if such is the case.

(b) Alternative Periodic Reporting. A broker or dealer may effect transactions for or with the account of a customer without giving or sending to such customer the written notification described in paragraph (a) of this section if:

(1) Such transactions are effected pursuant to a periodic plan or an investment company plan, or are effected in shares of any no-load open-end investment company registered under the Investment Company Act of 1940 that attempts to maintain a constant net asset value per share and that holds itself out to be a "money market" fund or has an investment policy calling for investment of at least 80% of its assets in debt securities maturing in 13 months or less; and

(2) Such broker or dealer gives or sends to such customer within five business days after the end of each quarterly period, for transactions involving investment company and periodic plans, and after the end of each monthly period, for other transactions described in paragraph (c)(1) of this section, a written statement disclosing each purchase or redemption, effected for or with, and each dividend or distribution credited to or reinvested for, the account of such customer during the month; the date of each such transaction; the identity, number, and price of any securities purchased or redeemed by such customer in each such transaction; the total number of shares of such securities in such customer's account; any remuneration received or to be received by the broker or dealer in connection therewith; and that any other information required by paragraph (a) of this section will be furnished upon written request: Provided, however, that the written statement may be delivered to some other person designated by the customer for distribution to the customer; and

(3) Such customer is provided with prior notification in writing disclosing the intention to send the written information referred to in paragraph (c)(1) of this section in lieu of an immediate confirmation.

* * * * *

(d) Definitions. For the purposes of this section,

* * * * *

(6) Investment company plan means any plan under which securities issued by an open-end investment company or unit investment trust registered under the Investment Company Act of 1940 are purchased by a customer (the payments being made directly to, or made payable to, the registered investment company, or the principal underwriter, custodian, trustee, or other designated agent of the registered investment company), or sold by a customer pursuant to

* * * * *

(9) Collateralized mortgage obligation means any debt security with two or more classes that:

(i) Requires payment to be made to holders of each class in accordance with a schedule specifying the relative priorities of payment to holders of all classes of the security;

(ii) Is secured by one or more mortgage notes or certificates of interest or participations in such notes; and

(iii) By its terms provides for payments in relation to payments, or reasonable projections of payments, on such mortgage notes or certificates of interest or participations in such notes.

(10) Riskless principal transaction means a transaction in which a dealer, after having received a buy order from a customer, purchases the security as principal from another person to offset a contemporaneous sale to such customer, or after having received a sell order from a customer, sells the security as principal to another person to offset a contemporaneous purchase from such customer.

* * * * *

3. By adding § 240.15c2-13 to read as follows:

§ 240.15c2-13 Confirmation of Municipal Securities Transaction.

(a) It shall be unlawful for any broker, dealer, or municipal securities dealer, acting as principal for its own account, to effect with the account of a customer any transaction in any municipal security unless the broker, dealer, or municipal securities dealer, at or before completion of the transaction, gives or sends to the customer written notification disclosing:

(1) In the case of a riskless principal transaction, the difference between the price to the customer and the dealer's contemporaneous purchase (for customer purchases) or sale price (for customer sales); and

(2) Whether the municipal security is unrated by a nationally recognized statistical rating organization.

(b) For purposes of this section:

(1) Customer shall not include a broker, dealer, or municipal securities dealer; and

(2) Completion of the transaction shall have the meaning provided in § 240.15c1-1 of this section.

(3) Riskless principal transaction means a transaction in which a dealer, after having received a buy order from a customer, purchases the security as principal from another person to offset a contemporaneous sale to such customer, or after having received a sell order from a customer, sells the security as principal to another person to offset a contemporaneous purchase from such customer.

By the Commission.

Jonathan G. Katz
Secretary

March 9, 1994

Route to:

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

Arbitrator Training

The Board wishes to apprise arbitrators of the following programs offered by other self-regulatory organizations (SROs) and non-SRO forums:

The American Arbitration Association (AAA), in cooperation with the American Stock Exchange, Inc., the New York Stock Exchange, Inc., the National Association of Securities Dealers, Inc., and a number of local and regional SROs, will present "Managing the Arbitration Process: A Training Seminar for Securities Arbitrators" on the following dates and locations:

April 21, 1994	Charleston, South Carolina
May 6, 1994	St. Louis, Missouri
June 24, 1994	Dallas, Texas
September 22, 1994	Chicago, Illinois

The Board is a co-sponsor of these one-day programs which are for individuals who currently serve, or have an interest in serving, as arbitrators in securities disputes. Registrants will have the opportunity to exchange ideas with nationally recognized securities experts, participate in panel discussions and review hearing procedures through the use of a specially designed, stop-action videotape.

Topics to be covered include:

- Review of Arbitration Procedures
- Hearing Procedures in Securities Arbitration
- Disclosure and Ethical Issues Confronting the Arbitrator
- Review of Recent Court Decisions: The Arbitrator's Powers and Duties

The fee for AAA dues-paying members is $165; $190 for non-members ($165 for MSRB-registered dealers). To register, or for further information, contact Bets Radley, AAA, Department of Education and Training, 140 West 51st Street, New York, NY 10020-1203, (212) 484-3233, Fax (212) 765-4874.

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Route to:

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

Financial Statements—Fiscal Years Ended September 30, 1993 and 1992

Report of Independent Accountants

To the Members of the
Municipal Securities Rulemaking Board, Inc.

We have audited the accompanying balance sheets of the Municipal Securities Rulemaking Board, Inc. (the Board) as of September 30, 1993 and 1992, and the related statements of revenues and expenses and changes in fund balance and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits using generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Municipal Securities Rulemaking Board, Inc. as of September 30, 1993 and 1992, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Coopers & Lybrand

Washington, D.C.
November 12, 1993

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.

BALANCE SHEETS

September 30, 1993 and 1992

ASSETS

	1993	1992
Cash and cash equivalents (Note 1)	$ 242,800	$ 559,614
Investments (Note 1)	6,694,188	4,046,826
Accounts receivable (Note 1)	1,033,681	676,728
Accrued interest receivable	57,050	40,224
Other assets	98,483	270,237
Fixed assets, net (Notes 1 and 5)	1,021,123	638,439
	$9,147,325	$6,232,068

LIABILITIES AND FUND BALANCE

	1993	1992
Accounts payable	$ 168,841	$ 155,564
Accrued vacation pay	61,609	51,119
Deferred rent credit (Note 2)	34,790	65,791
	265,240	272,474
Commitments (Notes 2 and 6)		
Fund balance	8,882,085	5,959,594
	$9,147,325	$6,232,068

The accompanying notes are an integral part of these financial statements.

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN FUND BALANCE

for the years ended September 30, 1993 and 1992

	1993	1992
Revenues:		
Assessment fees	$8,020,405	$5,959,480
Annual fees	276,300	265,200
Initial fees	24,300	18,600
Investment income	211,060	202,034
MSIL fees	67,895	19,679
Board manuals and other	94,985	103,886
	8,694,945	6,568,879
Expenses:		
Administration and operations	2,158,340	1,536,447
Board and committee	582,771	402,476
Professional qualifications	153,808	271,478
Arbitration	152,822	254,511
MSIL:		
Development (Note 6)	65,147	474,854
Operations (Note 6)	1,703,011	627,377
Education and communications	363,967	186,723
Rulemaking and policy development	592,588	446,034
	5,772,454	4,199,900
Excess of revenues over expenses	2,922,491	2,368,979
Fund balance, beginning of year	5,959,594	3,590,615
Fund balance, end of year	$8,882,085	$5,959,594

The accompanying notes are an integral part of these financial statements.

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.

STATEMENTS OF CASH FLOWS

for the years ended September 30, 1993 and 1992

	1993	1992
Cash flows from operating activities:		
Excess of revenues over expenses	$ 2,922,491	$ 2,368,979
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Depreciation and amortization	388,557	136,216
Amortization of investment premium/discount	63,075	64,148
Gain on sale of fixed assets	(8,436)	(14,890)
Increase in accounts receivable	(356,953)	(117,400)
Increase in interest receivable	(16,826)	(1,651)
(Increase) decrease in other assets	171,754	(249,572)
Increase (decrease) in accounts payable and accrued expenses	23,767	(33,118)
Decrease in deferred credit	(31,001)	(31,000)
Total adjustments	233,937	(247,267)
Net cash provided by operating activities	3,156,428	2,121,712
Cash flows from investing activities:		
Purchase of fixed assets	(800,219)	(536,263)
Proceeds from sale of fixed assets	37,427	46,727
Purchases of U.S. Treasury Notes	(5,110,450)	(3,885,180)
Maturities of U.S. Treasury Notes	2,400,000	2,600,000
Net cash used by investing activities	(3,473,242)	(1,774,716)
Net increase/(decrease) in cash and cash equivalents	(316,814)	346,996
Cash and cash equivalents, beginning of year	559,614	212,618
Cash and cash equivalents, end of year	$ 242,800	$ 559,614

The accompanying notes are an integral part of these financial statements.

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.

NOTES TO FINANCIAL STATEMENTS

1. Accounting policies

The Municipal Securities Rulemaking Board (the Board) was established in 1975 pursuant to authority granted by the Securities Exchange Act of 1934, as amended by the Securities Acts Amendments of 1975, as an independent, self-regulatory organization charged with rulemaking responsibility for the municipal securities industry. Effective May 17, 1989, the Board became incorporated as a nonprofit, nonstock corporation in the Commonwealth of Virginia.

Assessment fees

On March 10, 1992, the Board filed with the Securities and Exchange Commission an amendment to Rule A-13 on assessments relating to the underwriting of municipal securities offerings. The amendment relates to the Board's method of assessment, the scope of offerings which are assessed and assessment rates.

The underwriting assessment fee is equal to a percentage of the face amount of all municipal securities which are purchased from an issuer as part of a new issue. The fee charged ranges from .001% to .003% of the par value of the offerings.

Revenue from assessment fees is recognized when the underwriter files the offering statement with the Board.

Annual fees

Each municipal securities broker and municipal securities dealer is required to pay an annual fee of $100 with respect to each fiscal year of the Board in which the municipal securities broker or municipal securities dealer conducts business.

Initial fees

The initial fee is a one-time fee of $100, which is to be paid by every municipal securities broker or municipal securities dealer registered with the Securities and Exchange Commission.

Continued

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.
NOTES TO FINANCIAL STATEMENTS

Revenue from initial fees is recognized when received by the Board.

Investments

Investments in securities are stated at amortized cost, which approximates market value. Investments consist entirely of U.S. Treasury notes, maturing on various dates through May 1994. It is management's intention to hold each note through maturity.

Equipment, improvements, related depreciation and amortization

Furniture and equipment are recorded at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the shorter of the remaining lease period or the estimated useful life of the improvement.

When assets are retired or sold, the related cost and accumulated depreciation are removed from the accounts, and any gain or loss arising from such disposition is included in current operations.

Cash and cash equivalents

Cash and cash equivalents include cash on hand, time and demand deposits, and money market funds with maturities of three months or less. Portions of these funds consist of amounts that are maintained in excess of federally insured amounts, and, as a result, subject the Board to a degree of credit risk. The Board's policy is to limit credit risk by depositing its funds with high quality financial institutions.

2. Lease agreements

On November 16, 1984, the Board leased office space under a lease agreement expiring in November 1994. This agreement calls for the Board to receive a rent credit equal to

Continued

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.
NOTES TO FINANCIAL STATEMENTS

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one-half of the base monthly rent for the first 30 months of the lease. As a result, the monthly rental payments were $9,350 through May 1987 and are $18,700 a month for the remainder of the lease term, subject to an annual escalation based on the Consumer Price Index and a proportionate share of the increase in the costs of operating the building. For financial reporting purposes, the Board is recognizing rental expense evenly during the 10-year lease term at $16,105 a month. The Board is required to maintain an irrevocable letter of credit of $18,700, in lieu of a security deposit, payable to the lessor as part of the lease agreement. The lease may be renewed at the Board's option, for a period of five years, in accordance with the terms set forth in the lease agreement.

On October 1, 1992, the Board entered into a lease agreement for office space in Alexandria, VA, for a term of sixty months. This lease was amended in October, 1993 for additional space. The rental payments are $21,101 each month.

In August, 1993, the Boaard entered into a lease agreement for office space to replace the current lease agreement which expires in November, 1994. The lease term is for 120 months, commencing on March, 1994, with one five year renewal option. The lease inculdes periodic escalation clauses and pass through of building operating costs. The lease agreement also includes a rent abatment period of fifteen months commencing on the second month of the lease term.

Future minimum rental commitments are as follows:

Year ending September 30,	Minimum rentals
1994	$499,192
1995	318,194
1996	512,164
1997	512,164
1998 and thereafter	1,720,159
Total	$3,561,873

Total lease expense for office space and equipment for the years ended September 30, 1993 and 1992, was $619,649 and $415,730, respectively.

Continued

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.

NOTES TO FINANCIAL STATEMENTS

3. Retirement plans

The Board has a defined-contribution retirement plan. All employees are eligible to participate upon attaining a minimum length of service. The Board makes contributions to an insurance company based on a percentage of the salaries of covered employees and their lengths of service. Retirement plan costs are funded as they accrue. Employees may also make voluntary contributions. Cost of the plan was approximately $95,200 and $86,500 for the years ended September 30, 1993 and 1992, respectively.

The Board also has a deferred compensation plan which covers all employees. The Board contributes $.50 for every $1 contributed by an employee, with a maximum Board contribution of 2% of the employee's annual salary. The cost of this plan was approximately $17,200 and $16,000 for the years ended September 30, 1993 and 1992, respectively.

4. Income taxes

Under section 501(c)(6) of the Internal Revenue Code and applicable income tax regulations of the District of Columbia, the Board is exempt from taxes on income other than unrelated business income. No provision for income taxes has been made as of September 30, 1993 and 1992, since the Board believes that any unrelated business income is not significant.

5. Fixed assets

Fixed assets consist of the following as of September 30, 1993 and 1992:

	1993	1992
Leasehold improvements	$ 145,182	$ 71,834
Office equipment	1,035,502	782,997
Furniture and fixtures	557,590	252,485
	1,738,274	1,107,316
Accumulated depreciation and amortization	(717,151)	(468,877)
	$1,021,123	$ 638,439

Continued

MUNICIPAL SECURITIES RULEMAKING BOARD, INC.
NOTES TO FINANCIAL STATEMENTS

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6. MSIL

During 1991, the Board developed and established MSIL (Municipal Securities Information Library), an information storage and retrieval process which collects, stores and disseminates official statements and advance refunding documents.

The Board charges users of the MSIL system for information retrieval and copy. The fees for these services are recognized when rendered.

The Board expenses in the current period all development costs incurred in establishing MSIL, except for computer equipment which is capitalized and depreciation over the life of the asset. Costs of operating MSIL are expensed as incurred.

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.

October 1, 1993 .... $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.

1994 .... 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

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