MSRB REPORTS

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MSRB REPORTS (SSN-0277-0911) is published by the Municipal Securities Rulemaking Board, 1818 N Street, NW, Suite 800, Washington, DC 20036-2491. Editor: Thomas A. Hutton
POSTMASTER send address changes to Municipal Securities Rulemaking Board, 1818 N Street, NW, Suite 800, Washington, DC 20036-2491. Telephone (202) 223-9347 Fax (202) 872-0347

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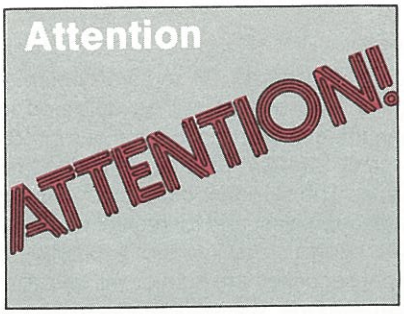

Route to:

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Stripped Coupon Municipal Securities

Notice

The Board provides guidance on the application of its rules to transactions in stripped coupon instruments that are defined as municipal securities by the SEC.

The Board's letter to the SEC requesting a definition whether certain stripped coupon instruments are municipal securities and the SEC's response follow this notice.

In 1986, several municipal securities dealers began selling ownership rights to discrete interest payments, principal payments or combinations of interest and principal payments on municipal securities. In 1987, the Board asked the Securities and Exchange Commission staff whether these "stripped coupon" instruments are municipal securities for purposes of the Securities Exchange Act and thus are subject to Board rules. On January 19, 1989, the staff of the Division of Market Regulation of the Commission issued a letter stating that, subject to certain conditions, these instruments are municipal securities for purposes of Board rules (SEC staff letter). A copy of the SEC staff letter and the Board's 1987 inquiry follow this interpretive notice.

The Board is providing the following guidance on the application of its rules to transactions in stripped coupon instruments defined as municipal securities in the SEC staff letter (stripped coupon municipal securities). **Questions whether other stripped coupon instruments are municipal securities and questions concerning the SEC staff letter should be directed to the Commission staff.**

Background

A dealer sponsoring a stripped coupon municipal securities program typically deposits municipal securities (the underlying securities) with a bank custodian. Pursuant to a custody agreement, the custodian separately records the ownership of the various interest payments, principal payments, or specified combinations of interest and principal payments. One combination of interest and principal payments sometimes offered is the "annual payment security," which represents one principal payment, with alternate semi-annual interest payments. This results in an annual interest rate equal to one-half the original interest rate on the securities.[1] Stripped coupon municipal securities are marketed under trade names such as Municipal Tax Exempt Investment Growth Receipts (Municipal TIGRs), Municipal Receipts (MRs), and Municipal Receipts of Accrual on Exempt Securities (MUNI RAES).

Application of Board Rules

In general, the Board's rules apply to transactions in stripped coupon municipal securities in the same way as they apply to other municipal securities transactions. The Board's rules on professional qualifications and supervision, for example, apply to persons executing transactions in the securities the same as any other municipal security. The Board's rules on recordkeeping, quotations, advertising and arbitration also apply to transactions in the securities. Dealers should be aware that rule G-19, on suitability of recommendations, and rule G-30, on fair pricing, apply to transactions in such instruments.

The Board emphasizes that its rule on fair dealing, rule G-17, requires dealers to disclose to customers purchasing stripped coupon municipal securities all material facts about the securities at or before the time of trade. Any facts concerning the underlying securities which materially affect the stripped coupon instruments, of course, must be disclosed to the customer. The Board understands that some stripped coupon municipal securities are sold without any credit enhancement to the underlying municipal securities. As pointed out in the SEC staff letter, dealers must be particularly careful in these cases to disclose all material facts relevant to the creditworthiness of the underlying issue.

Confirmation Requirements

Dealers generally should confirm transactions in stripped

Questions about this notice should be directed to Harold L. Johnson, Assistant General Counsel.

[1] The Board understands that other types of stripped coupon municipal securities also may be offered with combinations of interest and principal payments providing an interest rate different than the original interest rate of the securities.

coupon municipal securities as they would transactions in other municipal securities that do not pay periodic interest or which pay interest annually.[2] A review of the Board's confirmation requirements applicable to the securities follows.

Securities Descriptions. Rules G-12(c)(v)(E) and G-15(a)(i)(E) require a complete securities description to be included on inter-dealer and customer confirmations, respectively, including the name of the issuer, interest rate and maturity date.[3] In addition to the name of the issuer of the underlying municipal securities, the trade name and series designation assigned to the stripped coupon municipal security by the dealer sponsoring the program must be included on the confirmation.[4] Of course, the interest rate actually paid by the stripped coupon security (*e.g.*, zero percent or the actual, annual interest rate) must be stated on the confirmation rather than the interest rate on the underlying security. Similarly, the maturity date listed on the confirmation must be the date of the final payment made by the stripped coupon municipal security rather than the maturity date of the underlying securities.[5]

Credit Enhancement Information. Rules G-12(c)(vi)(D) and G-15(a)(ii)(D) require confirmations of securities pre-refunded to a call date or escrowed to maturity to state this fact along with the date of maturity set by the advance refunding and the redemption price. If the underlying municipal securities are advance-refunded, confirmations of the stripped coupon municipal securities must note this. In addition, rules G-12(c)(v)(E) and G-15(c)(i)(E) require that the name of any company or other person, in addition to the issuer, obligated directly or indirectly with respect to debt service on the underlying issue or the stripped coupon security be included on confirmations.[6]

Quantity of Securities and Denominations. For securities that mature in more than two years and pay investment return only at maturity, rules G-12(c)(v) and G-15(a)(v) require the maturity value to be stated on confirmations in lieu of par value. This requirement is applicable to transactions in stripped coupon municipal securities over two years in maturity that pay investment return only at maturity, *e.g.*, securities representing one interest payment or one principal payment. For securities that pay only principal and that are pre-refunded at a premium price, the principal amount may be stated as the transaction amount, but the maturity value must be clearly noted elsewhere on the confirmation. This will permit such securities to be sold in standard denominations and will facilitate the clearance and settlement of the securities.

Rules G-12(c)(vi)(F) and G-15(a)(iii)(G) require confirmations of securities that are sold or that will be delivered in denominations other than the standard denominations specified in rules G-12(e)(v) and G-15(a)(iii)(G) to state the denominations on the confirmation. The standard denominations are $1,000 or $5,000 for bearer securities, and for registered securities, increments of $1,000 up to a maximum of $100,000. If stripped coupon municipal securities are sold or will be delivered in any other denominations, the denomination of the security must be stated on the confirmation.

Dated Date. Rules G-12(c)(vi)(A) and G-15(a)(iii)(A) require that confirmations state the dated date of a security if it affects price or interest calculations, and the first interest payment date if other than semi-annual. The dated date for purposes of an interest-paying stripped coupon municipal security is the date that interest begins accruing to the custodian for payment to the beneficial owner. This date, along with the first date that interest will be paid to the owner, must be stated on the confirmation whenever it is necessary for calculation of price or accrued interest.

Original Issue Discount Disclosure. Rules G-12(c)(vi)(G) and G-15(a)(iii)(H) require that confirmations identify securities that pay periodic interest and that are sold by an underwriter or designated by the issuer as "original issue discount." This alerts purchasers that the periodic interest received on the securities is not the only source of tax-exempt return on investment. Under federal tax law, the purchaser of stripped coupon municipal securities is assumed to have purchased the securities at an "original issue discount," which determines the amount of investment income that will be tax-exempt to the purchaser. Thus, dealers should include the designation of "original issue discount" on confirmations of stripped coupon municipal securities, such as annual payment securities, which pay periodic interest.

Clearance and Settlement of Stripped Coupon Municipal Securities

Under rules G-12(e)(vi)(B) and G-15(a)(iv)(B), delivery of securities transferable only on the books of a custodian can be made only by the bookkeeping entry of the custodian.[7] Many dealers sponsoring stripped coupon programs provide customers with "certificates of accrual" or "receipts," which evidence the type and amount of the stripped coupon municipal

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[2] Thus, for stripped coupon municipal securities that do not pay periodic interest, rules G-12(c)(v) and G-15(a)(v) require confirmations to state the interest rate as zero and, for customer confirmations, the inclusion of a legend indicating that the customer will not receive periodic interest payments. Rules G-12(c)(vi)(H) and G-15(a)(iii)(I) require confirmations of securities paying annual interest to note this fact.

[3] The complete description consists of all of the following information:

> the name of the issuer, interest rate, maturity date, and if the securities are limited tax, subject to redemption prior to maturity (callable), or revenue bonds, an indication to such effect, including in the case of revenue bonds the type of revenue, if necessary for a materially complete description of the securities and in the case of any securities, if necessary for a materially complete description of the securities, the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to debt service or, if there is more than one such obligor, the statement "multiple obligors" may be shown.

[4] Trade name and series designation is required under rules G-12(c)(vi)(I) and G-15(a)(iii)(J), which state that confirmations must include all information necessary to ensure that the parties agree to the details of the transaction.

[5] Therefore, the maturity date of a stripped coupon municipal security representing one interest payment is the date of the interest payment.

[6] It should be noted that the SEC staff letter is limited to instruments in which "neither the custodian nor sponsor additionally will guarantee or otherwise enhance the creditworthiness of the underlying municipal security or the stripped coupon security."

[7] Under rules G-12(c)(vi)(B) and G-15(a)(iii)(B) the book-entry-only nature of the securities also must be noted on the confirmation.

securities that are held by the custodian on behalf of the beneficial owner. Some of these documents, which generally are referred to as "custodial receipts," include "assignment forms," which allow the beneficial owner to instruct the custodian to transfer the ownership of the securities on its books. Physical delivery of a custodial receipt is not a good delivery under rules G-12(e) and G-15(a) unless the parties specifically have agreed to the delivery of a custodial receipt. If such an agreement is reached, it should be noted on the confirmation of the transaction, as required by rules G-12(c)(v)(N) and G-15(a)(i)(N).

The Board understands that some stripped coupon municipal securities that are assigned CUSIP numbers and sold in denominations which are multiples of $1,000 are eligible for automated comparison and automated confirmation/affirmation and that some of these instruments also are eligible for book-entry delivery through registered securities depositories. The Board reminds dealers that transactions in stripped coupon municipal securities are subject to the automated clearance requirements of rules G-12(f) and G-15(d) if they are eligible in the automated clearance systems. Dealers sponsoring stripped coupon programs also should note that rule G-34(b)(ii) requires CUSIP numbers to be assigned to stripped coupon municipal securities prior to the initial sale of the securities to facilitate clearance and settlement.

Written Disclosures in Connection with Sales of Stripped Coupon Municipal Securities

Dealers sponsoring stripped coupon municipal securities programs generally prepare "offering circulars" or "offering memoranda" describing the securities that have been placed on deposit with the custodian, the custody agreement under which the securities are held, and the tax treatment of transactions in the securities. These documents generally are provided to all customers purchasing the securities during the initial offering of the instruments. The Board strongly encourages all dealers selling stripped coupon municipal securities to provide these documents to their customers whether the securities are purchased during the initial distribution or at a later time.[8] Although the material information contained in these documents, under rule G-17, must be disclosed to customers orally if not provided in writing prior to the time of trade, the Board believes that the unusual nature of stripped coupon municipal securities and their tax treatment warrants special efforts to provide written disclosures. Moreover, if stripped coupon municipal securities are marketed during the underwriting period of the underlying issue, rule G-32 requires distribution of the official statement for the underlying issue prior to settlement of the transaction of the stripped coupon municipal securities.

March 13, 1989

[8] The Board understands that these documents generally are available from the dealers sponsoring the stripped coupon municipal securities program.

Letter from the Board to the SEC

April 27, 1987

Richard Ketchum, Esq.
Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: *Stripped Coupon Municipal Securities*

Dear Mr. Ketchum:

I am writing to request the Commission's opinion whether, under section 3(a)(29) of the Securities Exchange Act, certain instruments which represent separate ownership of interest and principal payments on municipal securities ("stripped coupon municipal securities") are municipal securities.[1] These instruments are known by such trade names as Municipal Certificates of Accrual on Tax-Exempt Securities ("MCATS"), Municipal Investment Tax-Exempt Investment Growth Receipts ("Municipal TIGRs") and Municipal Receipts ("MRs"). Examples of offering circulars and a sample "certificate of accrual" for these instruments are enclosed for your information.†

A dealer sponsoring a stripped coupon municipal securities program typically deposits municipal securities with a bank custodian which, pursuant to a custody agreement, separately records ownership of the various interest payments, principal payments or specified combinations of interest and principal payments on the securities. The custodian generally provides "certificates of accrual" or "receipts" to the owners, stating the type and amount of the payments owned.[2] The custodian may require presentation of this document, properly executed by the owner, to transfer ownership on its books. Some programs permit the owner, under certain specified conditions, to obtain physical municipal securities from the custodian.[3]

The Board understands that stripped coupon municipal securities generally are being treated in the industry as munici-

[1] As you may be aware, several dealers began offering these instruments in 1986. This development was a result of certain provisions of the Tax Reform Act of 1986, which clarified the federal income tax treatment of a purchaser of a stripped coupon municipal security.

[2] The custodian holds the municipal securities as a fungible mass. Thus, a specific certificate of accrual or receipt is not identified as representing an interst or principal payment on a specific municipal securities certificate.

[3] It may be possible for the owner of an interest or principal payment on a bearer security to obtain a physical coupon or bond corpus from the custodian. If the municipal securities on deposit are registered securities, this is not possible. The owner of an interest or principal payment on a registered bond, however, may have a right to obtain a physical registered bond from the custodian if he presents certificates or receipts representing all of the remaining interest payments and the principal payment on a security.

pal securities rather than corporate securities issued by the dealer sponsoring the program. The CUSIP Service Bureau is assigning CUSIP numbers to the securities that are based on the issuer of the underlying municipal securites and they are being sold by qualified municipal securities dealers. The Board also understands that stripped coupon municipal securities are not being registered with the Commission as separate corporate securities under the Securities Act.

The Board has received a number of inquiries whether transactions in stripped coupon municipal securities are municipal securities and thus subject to the Board's rules, a determination only the Commission can make under section 3(b) of the Securities Exchange Act. If the securities are determined to be municipal securities, the Board plans to issue a notice on the application of its rules to these instruments. Currently, there is not total uniformity in the confirmation and processing of transactions in the securities and the Board is concerned that this may result in confusion in the marketplace.

The Board respectfully requests the Commission's opinion whether stripped coupon municipal securities are municipal securities for purposes of the Securities Exchange Act. Given that the securities already are being traded and sold to customers, the Board requests the Commission to review this issue as soon as possible. If you have questions concerning stripped coupon municipal securities or the Board's request, please do not hesitate to call me.

Sincerely,

Angela Desmond
General Counsel

† The Board provided additional offering circulars to the SEC in a letter, dated September 9, 1988.

SEC Response to the Board

January 19, 1989

Angela Desmond, Esq.
General Counsel
Municipal Securities Rulemaking Board
Suite 800
1818 N Street, N.W.
Washington, D.C. 20036-2491

Re: *Stripped Coupon Municipal Securities*

Dear Ms. Desmond:

Thank you for your letters, dated April 27, 1987 and September 9, 1988, in which you request our views regarding whether certain instruments representing separate rights to receive payment of the interest and principal portions of municipal securities ("stripped coupon securities") are municipal securities within the meaning of Section 3(a)(29) of the Securities Exchange Act of 1934 ("1934 Act") and therefore subject to the rules of the Municipal Securities Rulemaking Board ("MSRB") in accordance with Section 15B of the 1934 Act.

Based upon your letters, the sample offering circulars, and "certificate of accrual" that you enclosed, we understand the facts to be as follows.[1] In a typical stripped coupon securities program, the sponsoring dealer ("sponsor") deposits municipal securities with a custodian, pursuant to a custody agreement. The custodian is usually a bank that is not affiliated with the sponsor. The custodian separately records ownership of various interest or principal payments, or combinations thereof, on these municipal securities and provides "certificates of accrual" or "receipts" evidencing these ownership interests (collectively, "receipts"). Where the underlying municipal securities are issued in physical form, receipt holders may be provided the opportunity to exchange their receipts for the underlying coupons or bonds evidenced by their receipts.

The custody agreements usually provide that: (1) the custodian will hold the underlying municipal securities in its name, as bailee for the receipt holders, who are the beneficial owners thereof; (2) the receipt holders will have all the rights and privileges of owners of transferable securities, except that the custodian will have the exclusive right to hold the underlying securities; (3) the receipt holders will have the right, as the real parties in interest, to proceed directly and individually against the issuer of the underlying securities in whatever manner is deemed appropriate upon a default; (4) the receipt holders are not required to act in concert with other receipt holders; (5) the custodian is not authorized to assert the rights and privileges of the receipt holders unless specifically requested to do so by the receipt holders and the custodian agrees to take such action;[2] (6) neither the custodian nor the sponsor additionally will guarantee or increase the security regarding the receipts; (7) the underlying municipal securities are not assets of the custodian and are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the custodian;[3] (8) the custodian will notify the receipt holders of any default of the underlying municipal securities; and (9) the custodian will

[1] Although we have received your most recent letter, dated January 9, 1989, this response does not incorporate the facts presented in that letter.
[2] In this regard, we understand that custody agreements in these programs also may indicate that: (1) if a vote of the receipt holders is required, the custodian will provide the receipt holders with its proxy, and will vote solely in accordance with such proxies; and (2) the custodian will act only in accordance with an affirmative direction from the majority in interest of the receipt holders of the principal portion of the underlying securities, after notifying such receipt holders of the action.
[3] Of course, the custody of stripped municipal securities creates risk, however minimal, of neglect or fraudulent activity by the custodian. We understand that it is usual practice for the custodian to have a fidelity bond covering the risk of fraudulent activity by the custodian's employees.

distribute payments of principal received prior to maturity in accordance with the characterization of such payments by the issuer of the underlying municipal securities, or, if such characterization is unclear, seek a judicial determination of the relative rights of the receipt holders.

The disclosure documents describe the general terms of the program. Among other things, they contain a description of the program, methods of payment, transfer, exchange, and delivery of bonds, the custodian, the custody agreement, and the federal income tax consequences of holding the receipts.[4] A supplement is provided indicating the ownership interests represented by the receipts being offered, original denominations, maturity and interest payment dates, stated yields, and, where applicable, a brief description of eligible securities for advance refunding, as determined by the trust indenture for the underlying municipal securities.[5] In addition, the offering circulars indicate that copies of documents referred to in the offering circular may be obtained from the sponsor.

Response:

Based upon the facts presented in your letters and contained in the offering materials attached to your interpretive request, the Division would view these stripped coupon securities as municipal securities for purposes of Section 15B of the 1934 Act. Our position is conditioned, in part, upon the accuracy of representations contained in offering circulars presented to investors: that owners of the stripped coupon securities will have all the rights and privileges of owners of the underlying municipal securities; that each receipt holder, as a real party in interest, will have the right, upon default of the underyling municipal securities, to proceed directly and individually against the issuer of those securities; and that the receipt holder will not be required to act in concert with other receipt holders or the custodian.[6] Our position is further conditioned on the sponsor obtaining an opinion of counsel to this effect, as well as the following factors: (1) each receipt represents the entire interest in a discrete, identified interest payment or principal payment on the underlying municipal security; (2) the custodian bank performs only clerical or ministerial services on behalf of the receipt holders; (3) neither the custodian nor sponsor additionally will guarantee or otherwise enhance the creditworthiness of the underlying municipal security or the stripped coupon security; (4) the custodian undertakes to notify receipt holders in the event of a default, and forward to receipt holders copies of all communications from the issuer of the underlying municipal security to the bondholders; (5) an opinion of counsel is provided indicating that the underlying municipal securities will not be considered assets of either the sponsoring firm or custodian bank; and (6) other factors are not present, such as remarketing agreements, that would require the investors in the stripped coupon securities to rely upon the sponsor to obtain the benefit of their investment.[7]

The Division wishes to emphasize that broker-dealers and municipal securities dealers remain subject to the general antifraud provisions of the federal securities laws when selling stripped coupon securities. Accordingly, they must be familiar with the securities and have a reasonable basis for their recommendations.[8]

You should be aware that our position is based solely upon the facts and representations noted above. The Division expresses no view regarding the applicability of the 1934 Act provisions, other than the municipal securities dealer regulatory provisions mentioned above, to such stripped coupon municipal securities, or whether the stripped coupon securities are "separate securities" for purposes of the 1934 Act.[9] Moreover, in light of the continuing development of the market for stripped coupon securities, our position is subject to reconsideration in the future. If you have any questions on this matter, please call Brandon Becker, Associate Director, at 202/272-2866; or Larry Bergmann, Associate Director, at 202/272-2836.

Sincerely,

Richard G. Ketchum
Director

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[4] We understand that, under Section 1286 of the Internal Revenue Code of 1986 ("Code"), 26 U.S.C. 1286, purchasers of separated interest or principal payments from municipal securities are treated, solely for purposes of applying the original issue discount rules of the Code, as if they had purchased an obligation issued on the purchase date, having original issue discount. This permits tax-exempt municipal securities to be sold in a manner that generates a series of zero-coupon instruments with no current interest payments, while preserving the tax-exempt character to the extent of the original tax-exempt yield. The offering materials you have presented to us represent that the stripped coupon securities covered by those materials are tax-exempt.

[5] *Cf.* Item 202(f) under the Securities Act of 1933, 17 C.F.R. 229.202(f) (disclosure guidelines for American Depositary Receipts).

[6] We note that the sample offering circulars provided as exhibits to your letters contain no representations that the issuer of the underlying municipal securities has acknowledged an obligation to the receipt holders. This interpretive position is not intended to apply where the issuer has officially disavowed any obligation to the receipt holders.

[7] In this regard, we would emphasize that, as described above, the custodial arrangements generally are structured to ensure that the custodian's role is essentially passive and that in all material respects the receipt holder is the real party in interest and otherwise treated as the beneficial owner of an interest in the underlying municipal security. Any material change in the nature of these custody arrangements could lead to a different result regarding our determination that the stripped coupon securities are appropriately treated as municipal securities for purposes of Section 15B of the 1934 Act. *See, e.g., Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2nd Cir. 1985) and *SEC* v. *American Board of Trade*, 751 F.2d 529 (2nd Cir. 1984).

[8] See Securities Exchange Act Release No. 26100 (Sept. 22, 1988) (discussing the disclosure responsibilities of municipal underwriters). We note the statements in your September 9, 1988 letter regarding the adequacy of disclosure concerning the underlying securities of recent stripped coupon securities. You indicate that in certain situations "the credit or security of the underlying issues becomes material to investors purchasing the stripped coupon securities" (footnote omitted). Nevertheless, you state that "[t]he credit of the underlying issue may not be discussed in any offering circular provided to a purchaser of a stripped coupon municipal security." Particularly where the underlying securities have not been advance refunded, the Division believes that significant questions would be raised under the federal securities laws if such securities were sold to investors without disclosing material information, including factors relating to the creditworthiness of the underlying issue.

[9] Apart from whether stripped coupon securities may be considered "separate securities" for other purposes of the 1934 Act, the Division would regard them as distinct from the underlying municipal securities for purposes of calculating mark-ups. *See* Securities Exchange Act Release No. 24368 (April 21, 1987), 52 FR 15575 (discussing mark-up calculations on stripped coupon Treasury securities).

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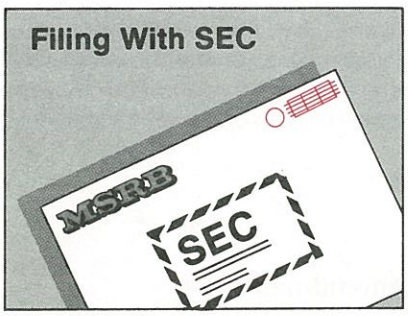

Route to:
- [X] Manager, Muni Dept.
- [ ] Underwriting
- [ ] Trading
- [ ] Sales
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- [ ] Public Finance
- [X] Compliance
- [ ] Training
- [ ] Other _____

Payment or Escrow of Arbitration Awards: Rule G-35

Amendment Filed

The proposed amendment would require a dealer, within 20 days after receipt of an arbitration award against it, either to pay the award or, if the dealer is considering an appeal of the award, to deposit the amount of the award in an escrow account set up for this purpose by the dealer or to provide to the prevailing party an irrevocable standby letter of credit for the amount of the award.

On March 14, 1989, the Board filed with the Securities and Exchange Commission a proposed amendment to rule G-35, on arbitration, which would require dealers to pay arbitration awards promptly or, if a dealer is considering an appeal of the award, escrow the amount of the award or obtain a letter of credit for the amount of the award for the benefit of the prevailing party. The amendment will become effective upon approval by the Commission. Persons wishing to comment on the amendment should comment directly to the Commission.[1]

Background

Rule G-35, the Board's Arbitration Code, and rule G-17, on fair dealing, require dealers to pay arbitration awards promptly unless a timely motion to vacate the award has been made according to applicable law.[2] Notwithstanding this requirement, it appears that a number of dealers do not pay arbitration awards until the very end of the appeal period even when they have no intention of bringing an appeal. Moreover, the Board is concerned about certain cases in which dealers have filed appeals solely for the purpose of delaying payment of awards in anticipation of going out of business. Such situations are inconsistent with the Board's statutory mandate to protect investors and undermine the goals of the Board's arbitration program: to provide a relatively quick and inexpensive means of resolving disputes involving municipal securities dealers.

Summary of Amendment

The proposed amendment would require a dealer, within 20 days after receipt of an arbitration award against it, either to pay the award or, if the dealer is considering an appeal of the award, to deposit the amount of the award in an escrow account set up for this purpose by the dealer or provide to the prevailing party an irrevocable standby letter of credit for the amount of the award.

If the dealer chooses to escrow the amount of the award, the amount of the award would be deposited with the bank in an escrow account pursuant to an escrow agreement subject to instructions consistent with the requirements of the proposed amendment. If an appeal is not filed by the relevant state or federal law deadline, or is filed but later withdrawn by the dealer prior to the entry of a final court order on the appeal, the escrow agreement must provide that the deposited funds would be delivered by the escrow agent to the prevailing party. If a final court order is obtained, the escrow agreement must provide for the delivery of the deposited funds pursuant to the court order.

If a dealer chooses to provide a letter of credit for the amount of the award, the dealer must provide that the amount of the award will be distributed to the prevailing party by the letter of credit issuer under certain circumstances. The letter of credit must provide for payment upon certification by the prevailing party that: (1) the dealer has not paid the amount of the award and an appeal has not been filed by appeal date, or (2) an appeal was filed but later withdrawn by the dealer prior to the entry of a final court order, or (3) a final court order on the appeal has been entered in favor of the prevailing party. Any costs incurred in the escrow account or in the application for and issuance of the letter of credit would be borne by the dealer.

The Board believes that a dealer should pay an award promptly and the 20 day period in the proposed amendment is adequate to obtain the necessary amount of money or make escrow or letter of credit arrangements. An additional benefit of the proposed amendment would be that, if the prevailing party does not receive payment of the award or notice of deposit of

Questions about this notice may be directed to Ronald W. Smith, Legal Assistant.

[1] SEC File No. SR-MSRB-89-3. Comments filed with the Commission should refer to the file number.

[2] The Federal Arbitration Act requires that an application to vacate an arbitration award be made within three months after the award is filed or delivered. The states that have adopted arbitration statutes usually allow between 30 and 90 days to file an application to vacate an arbitration award.

the funds within the 20 day period, the prevailing party could contact the appropriate enforcement agency. The enforcement agency then could bring an immediate action against the dealer for failing to comply with the rule, rather than waiting for the statutory appeal period to expire.

Summary of Comments

In December 1988, the Board solicited comments on an exposure draft and received seven comment letters and one oral comment.[3] Three commentators generally supported adoption of the proposed amendment as published in the exposure draft. One commentator stated that it is unfair when respondents take the entire 90 day appeal period to pay an award even if they do not plan to appeal. One commentator noted that it had to seek assistance from the NASD to collect funds from another dealer that had failed to make payment of an arbitration award. Two of the commentators stated that the proposed amendment should apply to dealers involved in both customer and inter-dealer disputes

Three commentators opposed the proposed amendment as published in the exposure draft. One commentator stated that the number of dealers that do not pay arbitration awards because they have ceased doing business or have filed for bankruptcy is probably minimal and, therefore, the proposed amendment is unnecessary. During the last year, one dealer's bankruptcy resulted in nonpayment of a number of arbitration awards to customers in Board arbitration proceedings even though the dealer had adequate funds to pay the awards when they were issued. Moreover, the Board believes that if a dealer goes bankrupt but has deposited the award amount in an escrow account or obtained a letter of credit on behalf of the prevailing party, the prevailing party will benefit. For example, if the arbitration award is deposited into an escrow account prior to 90 days before the filing of bankruptcy, this probably would be a legal transfer under the Bankruptcy Code and would not be attached by the bankruptcy trustee. Even if the funds deposited within 90 days of bankruptcy are attached by the bankruptcy trustee and considered a void transfer, these assets would have been preserved for the bankruptcy estate and be available for the claims of customers and general creditors. In addition, two commentators stated that the proposed amendment penalizes dealers wishing to exercise their rights to appeal adverse arbitration awards. The Board believes that the proposed amendment does not penalize a dealer's right to appeal; it only ensures that, if they do not appeal, or if they do appeal but the appeal is unsuccessful, the amount of the award would be available to the prevailing party.

In response to comments, the Board revised the draft amendment to allow dealers the alternative to obtain a letter of credit on behalf of the prevailing party and to extend the applicable time frame from 10 to 20 calendar days. In addition, while two commentators agreed that interest earned on an escrow account should be provided to the prevailing party, as proposed in the exposure draft, the Board deleted the requirement for an interest-bearing escrow account because it is reluctant to modify the terms of arbitration awards; also, some might interpret the interest requirement as a penalty. The Board determined that the proposed amendment should ensure that prevailing parties receive the amount of the award. If arbitrators provided for post-award interest in their awards, however, such interest becomes part of the award amount and would have to be provided for in any escrow or letter of credit arrangement.

March 14, 1989

Text of Proposed Amendment*

Rule G-35. Arbitration

Section 31. *Awards*

(a) through (d) No change.

(e) Upon receipt by a broker, dealer or municipal securities dealer ("dealer") of a monetary award rendered against it, the dealer, within 20 days, shall:

(1) deliver the amount of the award to the prevailing party (subject to any action required of the prevailing party by the award as a precedent to payment), or

(2)(i) if the dealer is considering an appeal of the award:

(A) deposit the amount of the award with a bank (the "escrow agent") in an escrow account pursuant to an escrow agreement which includes certain provisions described below, or

(B) provide to the prevailing party an irrevocable standby letter of credit ("letter of credit") for the amount of the award setting forth the terms and conditions for payment described below.

(ii) Immediately upon deposit by the dealer of the amount of the award in an escrow account, the dealer must notify the prevailing party in writing of the deposit of the arbitration award, the name and address of the escrow agent, and the final date an appeal may be filed according to relevant state or federal law ("appeal date"). The escrow agent must provide that, if an appeal is not filed by the appeal date, or filed but later withdrawn by the dealer prior to the entry of a final court order, the escrow agent will deliver the amount of the award to the prevailing party within two business days after the appeal date or the withdrawal date. If an appeal is filed, the amount of the award shall be held by the escrow agent until the entry of a final court order on the appeal. Within 10 business days of the entry of the final court order, the escrow agreement must provide that the escrow agent will deliver the amount of the award in accordance with the court's order.

(iii) If a letter of credit is provided, it must provide that the amount of the award will be disbursed to the prevailing party by the letter of credit issuer upon certification by the prevailing party that the dealer has not paid the amount of the award and:

(A) an appeal has not been filed by appeal date, or

(B) an appeal has been filed but later withdrawn by the dealer prior to the entry of a final court order, or

(C) a final court order on the appeal has been entered in favor of the prevailing party.

(iv) Any costs incurred in this escrow account or in the application for and issuance of the letter of credit shall be borne by the dealer.

(e) and (f) renumbered (f) and (g)

[3] *MSRB Reports* Vol. 8, No. 5 at 13-14 (December 1988). The comment letters are available for inspection at the Board's Offices.

* Underlining indicates new language.

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Route to:

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

Qualifications of Financial and Operations Principals: Rule G-3

Comments Requested

The Board requests comments on draft amendments which would eliminate the Board's FINOP examination and require all persons wishing to become municipal securities FINOPs to do so by qualifying with the NASD as a FINOP.

Rule G-3, on professional qualifications, requires securities firms that engage in municipal securities transactions to have at least one associated person qualified as a financial and operations principal (FINOP).[1] A FINOP supervises the financial reporting and net capital compliance required by SEC rules and the processing, clearance, and safekeeping of municipal securities by the securities firm. Under Board rule G-3(d), an individual may qualify as a FINOP by passing either the Board's Financial and Operations Principal Qualification Examination (Test Series 54) or by being qualified as a FINOP by the National Association of Securities Dealers (NASD). The NASD qualifies FINOPs through its FINOP Examination (Test Series 27). Over the past five years, use of the Board's FINOP examination has been negligible. Therefore, the Board requests comment on a draft amendment to rule G-3 which would eliminate the Board's FINOP examination and require all persons wishing to become municipal securities FINOPs to do so by qualifying with the NASD as a FINOP.

Qualification as a FINOP

The specific duties of a municipal securities FINOP, as set forth in rule G-3(a)(ii), include:

> Approval of and responsibility for financial reports required to be filed with the SEC or any self-regulatory organization, such as the NASD;
>
> Final preparation of such reports;
>
> Overall supervision of persons who assist in the preparation of these reports;
>
> Overall supervision of and responsibility for individuals who are involved in the maintenance of books and records from which these reports are derived;
>
> Overall supervision and performance of the securities firm's responsibilities pursuant to the financial responsibility rules under the Securities Exchange Act of 1934, as amended; and
>
> Overall supervision and responsibility for individuals who are involved in the processing, clearance and safekeeping functions of the securities firm.

The chief financial officer of a firm must be qualified as a FINOP. The head of the operations department also usually is a FINOP.[2]

As noted previously, a FINOP may become qualified in two ways: by passing the Board's FINOP examination or by being qualified as a FINOP by the NASD. The Board's FINOP examination is a three-hour "paper and pencil" examination with 66 multiple choice questions and additional arithmetical problems which test the candidate's ability to perform net capital and reserve formula computations regarding municipal securities. Developed by the Board in 1978 and administered by the NASD, the Board's FINOP examination is designed to test a candidate's knowledge of applicable Board and SEC rules and statutory provisions pertaining to financial responsibility and recordkeeping as well as the protections afforded investors under the Securities Investor Protection Act of 1970. The FINOP

Comments on the matters discussed in this notice should be submitted no later than June 23, 1989, and may be directed to Diane G. Klinke, Deputy General Counsel. Written comments will be available for public inspection.

[1] As noted below, introducing brokers and bank dealers are exempt from this requirement.

[2] The FINOP qualification category does not apply to individuals associated with bank dealers because the SEC's net capital requirements do not apply to bank dealers. The individual with policy-making authority for the processing and clearance of municipal securities for a bank dealer is required to qualify as a municipal securities principal. In addition, introducing brokers are not required to have an associated person qualified as a FINOP because they have limited contact with customer funds and securities and are exempt from most of the SEC's net capital requirements.

examination used by the NASD qualifies candidates to supervise the financial and operations activities of firms handling both municipal and corporate securities and includes questions on financial responsibility rules, SEC recordkeeping rules and NASD uniform practice rules.[3] In addition, this examination also tests a candidate's knowledge of the Board's recordkeeping and uniform practice requirements.[4]

Discussion and Request for Comment

When the Board's FINOP examination was developed in 1978, FINOPs from all previously unregistered municipal securities dealers were required to take either the Board's or the NASD's FINOP examination. Most took the Board's FINOP examination because, at the time, there were significant differences in the net capital treatment of municipal securities under SEC rules. Since then, however, fewer and fewer FINOP candidates satisfy their examination requirement by taking the Board's FINOP examination.[5] This may be because there are fewer municipal securities-only firms qualifying FINOPs, there are fewer differences in the treatment of municipal securities and other securities in the SEC's net capital rule, or because municipal securities-only firms, like most general securities firms, prefer that their FINOP candidates qualify under the NASD's more comprehensive examination. Because so few Board FINOP examinations are given, the Board is considering eliminating it.

The NASD currently is revising the test specifications of its FINOP examination. These revised specifications will include, among other things, a section devoted exclusively to questions on Board rules, including G-8 and G-9 on recordkeeping, rules G-12 and G-15 on uniform practice, deliveries to customers, and automated clearance and settlement, and rule G-27 on supervision. Also, the Board and the NASD are in the process of reaching an agreement that the questions contained in the NASD's FINOP examination regarding Board rules will be provided or reviewed by the Board.

The Board requests comment on the draft amendments from interested persons. In particular, the Board seeks comment on any benefit to municipal securities dealers of retaining the Board's FINOP examination and whether municipal securities dealers may be disadvantaged by being required to qualify FINOPs solely through the NASD's qualification process, including the requirement to take and pass the NASD's FINOP examination.

The draft amendments also include certain technical changes to rule G-3.

March 29, 1989

Text of Draft Amendments*

Rule G-3. *Classification of Principals and Representatives; Numerical Requirements; Testing*

(a) Definitions. As used in the rules of the Board, the terms "municipal securities principal," "financial and operations principal," "municipal securities representative," and "municipal securities sales principal" shall have the following respective meanings:

(i) No change.

(ii) The term "financial and operations principal" means a natural person associated with a broker, dealer ~~municipal securities broker~~ or municipal securities dealer (other than a bank dealer or a broker, dealer or municipal securities dealer meeting the requirements of paragraph (a)(2) or (3) of rule 15c3-1 under the Act or exempted from the requirements of rule 15c3-1 in accordance with paragraph (b)(3) thereof), whose duties include:

(A) through (G) No change.

(iii) and (iv) No change.

(b) Numerical Requirements.

(i) No change.

(ii) Financial and Operations Principals. Every broker, dealer, ~~municipal securities broker~~ and municipal securities dealer (other than a bank dealer and a broker, dealer, or municipal securities dealer meeting the requirements of paragraphs (a)(2) or (3) of rule 15c3-1 under the Act or exempted from the requirements of rule 15c3-1 in accordance with paragraph (b)(3) thereof), shall have at least one financial and operations principal, including its chief financial officer, qualified in accordance with section (d) of this rule~~, provided, however, that the numerical requirements of this paragraph shall not apply to any municipal securities broker or municipal securities dealer meeting the requirements of paragraphs (a)(2) or (3) of rule 15c3-1 under the Act or exempted from the requirements of rule 15c3-1 in accordance with paragraph (b)(3) thereof~~.

(c) No change.

(d) Qualification Requirements for Financial and Operations Principals.

(i) Except as otherwise provided in this section (d), every financial and operations principal shall ~~take and pass the Municipal Securities Rulemaking Board Financial and Operations Principal Qualification Examination prior to being qualified as a financial and operations principal. The passing grade shall be determined by the Board.~~ be qualified in such capacity in accordance with the rules of a registered securities association.

(ii) Any person who ceases to be associated with a ~~municipal~~

[3] The test is administered on the PLATO System of Control Data Corporation.

[4] Rule G-3 includes a provision allowing the NASD to waive the FINOP examination for certain individuals in appropriate circumstances. This provision occasionally was used in the late 70s and early 80s as the NASD dealt with previously unregistered municipal securities dealers seeking to comply with Board rules. Since 1981, however, few waivers have been granted.

[5] Since 1984, the number of persons taking the Board's FINOP examination are as follows:

1984 - 3
1985 - 15
1986 - 6
1987 - 2
1988 - 1

* Underlining indicates new language; strikethrough indicates deletions.

~~securities~~ broker, dealer, or municipal securities dealer as a financial and operations principal for two or more years at any time after having qualified as such in accordance with this section (d) shall ~~take and pass the Financial and Operations Principal Qualification Examination prescribed by the Board~~ qualify in such capacity in accordance with the rules of a registered securities association prior to being qualified as a financial and operations principal.

~~(iii) The requirements of paragraph (d)(i) and (d)(ii) of this rule shall not apply to any financial and operations principal who is:~~

~~(A) registered and qualified in such capacity with a registered securities association, or~~

~~(B) associated with a municipal securities broker or municipal securities dealer meeting the requirements of paragraphs (a)(2) or (3) of rule 15c3-1 under the Act or exempted from the requirements of rule 15c3-1 in accordance with paragraph (b)(3) thereof.~~

~~(iv)~~ (iii) The requirements of this section (d) may be waived for any associated person of a broker, dealer ~~municipal securities broker~~ or municipal securities dealer in circumstances sufficient to justify the granting of a waiver if such person were seeking to register and qualify with a member of a registered securities association as a financial and operations principal. Such waiver may be granted

~~(A)~~ by a registered securities association with respect to a person associated with a member of such association~~, or~~

~~(B) by the Commission with respect to a person association with any other municipal securities broker or municipal securities dealer (other than a bank dealer).~~

(e) through (i) No change.

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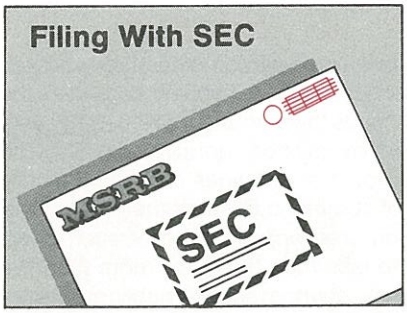

Route to:

- [X] Manager, Muni Dept.
- [ ] Underwriting
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- [X] Compliance
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Arbitration Changes: Rule G-35

Amendments Filed

The amendments would—

- **permit the Director of Arbitration to assign cases that do not exceed $30,000 to a single arbitrator;**
- **revise pending amendments concerning challenges to arbitrators and disclosure of predispute arbitration agreements; and**
- **make certain other technical changes.**

On March 2 and 7, 1989, the Board filed with the Securities and Exchange Commission (Commission) amendments to rule G-35, the Board's Arbitration Code. The proposed amendments filed on March 2 revise amendments that are waiting SEC approval regarding, among other things, challenges to arbitrators and disclosure regarding predispute arbitration agreements.[1] The proposed amendments filed on March 7 relate to the composition of certain arbitration panels.[2] The proposed amendment regarding predispute arbitration agreements will be effective three months after Commission approval in order to allow dealers to revise their customer account agreements to include the required disclosures. The remaining amendments will become effective upon approval by the Commission.[3]

Composition of Arbitration Panels

Proposed Section 12 of rule G-35 provides that arbitration cases over $10,000 are decided by a panel of three arbitrators.[4] The proposed amendment revises Section 12 to permit the Director of Arbitration to assign cases that do not exceed $30,000 to a single arbitrator (either a public arbitrator for customer cases or an industry arbitrator for industry cases). At the request of a party in its initial complaint or answer, or at the request of the designated arbitrator, the Director of Arbitration would be required to designate a panel of three arbitrators. All cases over $30,000 would continue to be decided by a panel of three arbitrators.

The proposed amendment should reduce costs and delays in arbitration proceedings while preserving the opportunity to be heard before a three-person panel upon timely motion of a party or the designated arbitrator. The Board received 115 arbitration cases in 1988. Of these cases, claimants in 64 cases asked for under $10,000 in damages and, under proposed Sections 34 and 35, these cases would have been decided by one arbitrator, usually without a hearing, under the small claims procedure. Claimants in another 20 cases asked for damages between $10,000 and $30,000. These cases were decided by panels of three arbitrators at a hearing. If the parties agree to have cases involving claims between $10,000 and $30,000 decided by only one arbitrator at a hearing the administrative burdens of a case, as well as arbitrator transportation costs, would be reduced dramatically. In addition, scheduling problems would be lessened when only one arbitrator's schedule has to be considered. The proposed amendment also will reduce the demand on the Board's arbitrator pool.

Other Amendments

Definitions of Industry and Public Arbitrators

The Board's proposed definition of industry and public arbitrators allows attorneys and other professionals who perform a substantial amount of municipal securities-related work for dealers to act as public arbitrators. Under proposed Section 8(c), however, public customers are allowed a challenge for cause if they are concerned about any possible bias on the part of such persons. The proposed amendment revises this section to allow challenges for cause for such persons who perform a substantial amount of work for dealers, whether or not related to municipal securities.

Decisions by Selected Arbitrators

The proposed amendments to Section 22(e) allow the Direc-

Questions about this notice may be directed to Diane G. Klinke, Deputy General Counsel.

[1] SEC File No. SR-MSRB-88-5, Amendment No. 1. Comments filed with the Commission should refer to the file number. *See MSRB Reports*, Vol. 8, No. 5 (December, 1988) for a description of the pending amendments.

[2] SEC File No. SR-MSRB-89-1.

[3] In addition, on November 23, 1988, the Board filed certain policies and procedures it follows in the arbitration program (SEC File No. SR-MSRB-88-6). *See MSRB Reports*, Vol. 8, No. 5 (December 1988). Because of certain revisions to these policies suggested by the Commission staff, the Board withdrew the filing on January 4, 1989.

[4] In certain complicated cases, the Director of Arbitration may appoint a panel of five arbitrators to hear the case. Cases under $10,000 are decided by one arbitrator, usually without a hearing, under the Board's small claims procedure.

tor of Arbitration, with the agreement of a majority of the arbitration panel, to appoint one member of the panel to decide all unresolved information and document issues prior to the hearing. The arbitrator is authorized to issue subpoenas, direct appearances of witnesses and production of documents, and set deadlines on behalf of the panel in order to expedite the arbitration proceeding. The proposed amendment authorizes the arbitrator to decide such issues not just to expedite the arbitration process but also "to permit any party to develop fully its case." The Board will remind arbitrators that information sought must be shown to be relevant prior to issuing an order of production.

Predispute Arbitration Agreements

Proposed Section 36 provides that certain disclosures regarding the effect of arbitration be included by dealers in any predispute arbitration agreement with customers. The proposed amendment requires that the disclosure language be printed in the outline form set forth in the section. In addition, the statement in the customer account agreement to be signed by the customer indicating acceptance of the provisions of the agreement would highlight the fact that the agreement contains an arbitration clause and note the page and paragraph number of the arbitration agreement.

Other more technical changes are included in the text of the proposed amendments.

March 10, 1989

Text of Proposed Amendments*

Rule G-35. Arbitration

Sections 1 through 7 No change.

Section 8. *Composition and Appointment of Panels*

(a) and (b) No change.

(c) Objections

(i) No change.

(ii) Each party who is a person other than a broker, dealer, municipal securities dealer, government securities broker or government securities dealer, shall be granted a challenge for cause to a public arbitrator, as defined in Section 12(c), who: (i) has been retired from a broker, dealer, municipal securities dealer, government securities broker or government securities dealer for over three years, or (ii) is an attorney, accountant or other professional who devoted 30 percent or more of his professional work effort within the last two years to ~~the municipal securities activities of~~ clients who are brokers, dealers or municipal securities dealers.

Sections 9 through 11 No change.

Section 12. *Designation of Number of Arbitrators and Definitions of Industry and Public Arbitrators*

(a) Controversies Involving Persons Other Than Brokers, Dealers or Municipal Securities Dealers

(1) ~~Except as otherwise provided in this Arbitration Code,~~ In all arbitration matters in which a person other than a broker, dealer or municipal securities dealer is involved and where the matter in controversy exceeds the amount of ~~$10,000~~ $30,000, or where the matter in controversy does not involve or disclose a money claim or the amount of damages cannot be readily ascertained at the time of commencement of the proceeding, the Director of Arbitration shall appoint an arbitration panel which shall consist of no less than three nor more than five arbitrators, at least a majority of whom shall be public arbitrators as defined in paragraph (c), below, unless such person requests a panel consisting of a majority of industry arbitrators as defined in paragraph (c), below.

(2) Except as otherwise provided in Section 34 of this Arbitration Code, in all arbitration matters in which a person other than a broker, dealer, or municipal securities dealer is involved and where the matter in controversy does not exceed the amount of $30,000, the Director of Arbitration shall appoint a single public arbitrator, as defined in paragraph (c), below, to decide the matter in controversy. Upon the request of a party in its initial filing or the arbitrator, the Director of Arbitration shall appoint a panel of three arbitrators which shall decide the matter in controversy at least a majority of whom shall be public arbitrators unless the person other than a broker, dealer, or municipal securities dealer requests a panel consisting of at least a majority of industry arbitrators, as defined in paragraph (c), below.

(b) Intra-Industry Controversies

(1) ~~Except as otherwise provided in this Arbitration Code,~~ In all arbitration matters between or among brokers, dealers, and municipal securities dealers, or persons associated with brokers, dealers, and municipal securities dealers, where the matter in controversy exceeds the amount of $30,000, a panel shall consist of no less than three nor more than five industry arbitrators, as defined in paragraph (c), below, as determined by the Director of Arbitration.

(2) Except as otherwise provided in Section 35 of this Arbitration Code, in all arbitration matters between or among brokers, dealers, and municipal securities dealers, or persons associated with brokers, dealers, and municipal securities dealers, and where the matter in controversy does not exceed the amount of $30,000, the Director of Arbitration shall appoint a single industry arbitrator, as defined in paragraph (c), below, to decide the matter in controversy. Upon the request of a party in its initial filing or the arbitrator, the Director of Arbitration shall appoint a panel of three industry arbitrators.

(c) Definitions of Industry and Public Arbitrators

(1) An industry arbitrator:

(i) and (ii) No change.

(iii) is an attorney or other professional who devoted 20 percent of more of his professional work effort within the last two years in either or both of the following areas: (A) as counsel to a broker, dealer or municipal securities dealer acting as the underwriter of an issue of municipal securities, or (B) as counsel to or expert witness for a broker, dealer, municipal securities dealer, government securities broker or government securities dealer in securities-related litigation or arbitration proceedings against a person other than a broker, dealer, municipal securi-

* Underlining indicates additions; strikethrough indicates deletions.

ties dealer, government securities broker, or government securities dealer.

(2) A public arbitrator is a person other than an industry arbitrator.

(3) A person will not be classified ~~either~~ as a public ~~or industry~~ arbitrator if he or she has a spouse or other member of the household who is a person associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer.

Sections 13 through 21 No change.

Section 22. *Discovery*

(a) Requests for Documents and Information

The parties shall cooperate to the fullest extent practicable in the voluntary exchange of documents and information to expedite the arbitration. Any request for documents or other information should be specific, relate to the matter in controversy, and afford the party to whom the request is made a reasonable period of time to respond without interfering with the time set for the hearing.

(b) Document Production and Information Exchange

(1) through (3) No change.

(4) Upon the written request of a party whose information request is unsatisfied, the matter may be referred by the Director of Arbitration, with the consent of a majority of the arbitration panel, to a selected arbitrator under paragraph ~~(d)~~(e) of this section.

(c) Pre-hearing Exchange

At least ten 10 calendar days prior to the first scheduled hearing date, all parties shall serve on each other copies of documents in their possession and ~~shall~~ identify witnesses they intend to present at the hearing. The arbitrators may exclude from the arbitration any documents not exchanged or witnesses not identified at that time. This paragraph does not require service of copies of documents or identification of witness which parties may use for cross-examination or rebuttal.

(d) No change.

(e) Decisions by Selected Arbitrator

With the consent of a majority of the panel of arbitrators, the Director of Arbitration may appoint a single member of the Arbitration Panel to decide all unresolved issues referred to under this section and Section 23. Such arbitrator shall be authorized to act on behalf of the panel to issue subpoenas, direct appearances of witnesses and production of documents, set deadlines for compliance, and issue any other decision which will expedite the arbitration proceedings or is necessary to permit any party to develop fully its case. Decisions under this paragraph shall be made upon the papers submitted by the parties, unless the arbitrator calls a hearing. The arbitrator may elect to refer any issue under this paragraph to the full panel.

Sections 23 through 26 No change.

Section 27. *Record of Proceedings*

A verbatim record by stenographic reporter or tape recording of all arbitration hearings shall be kept. If a party or parties to a dispute elect to have the record transcribed, the cost of such transcription shall be borne by the party or parties making the request unless the arbitrators direct otherwise. The arbitrators may also direct that the record be transcribed. If the record is transcribed at the request of any party, a copy shall be provided to the arbitrators.

Sections 28 through 33 No change.

Section 34. Simplified Arbitration for Small Claims Relating to Transactions with Customers

(a) and (b) No change.

(c) The claimant shall ~~pay the sum of~~ deposit $15 if the amount in controversy is $1,000 or less, $25 if the amount is more than $1,000 but does not exceed $2,500 ~~or less~~, $100 if the amount in controversy is more than $2,500 but does not exceed $5,000, or $200 if the amount in controversy is more than $5,000 but does not exceed $10,000 upon filing of the Submission Agreement. The final disposition of this ~~sum~~ deposit shall be determined by the arbitrator.

(d) and (e) No change.

(f) The claim, dispute or controversy shall be submitted to a single public arbitrator ~~knowledgeable in the municipal securities industry~~ selected by the Director of Arbitration. Unless the customer demands or consents to a hearing, or the arbitrator calls a hearing, the arbitrator shall decide the claim, dispute or controversy solely upon the pleadings and evidence submitted by the parties. If a hearing is necessary, such hearing shall be held as soon as practicable at a locale selected by the Director of Arbitration. The choice of locale by the Director of Arbitration may be reviewed by the Arbitration Committee if a party to a proceeding promptly files a request for review with the Director of Arbitration.

(g) through (l) No change.

Section 35 No change.

Section 36. *Predispute Arbitration Agreements with Customers*

(1) Any predispute arbitration clause shall be highlighted and shall be immediately preceded by the following disclosure language (printed in outline form as set forth herein) which shall also be highlighted:

(a) Arbitration is final and binding on the parties.

(b) The parties are waiving their right to seek remedies in court, including the right to a jury trial.

(c) Pre-arbitration discovery is generally more limited than and different from court proceedings.

(d) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.

(e) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

(2) Immediately preceding the signature line, there shall be a statement, which shall be highlighted, that the agreement contains a predispute arbitration clause. The statement also shall indicate at what page and paragraph the arbitration clause is located.

(3) A copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(4) No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.

(5) The requirements of this section shall apply only to new agreements signed by an existing or new customer of a dealer after [insert delayed effective date].

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Notice of Approval

Route to:

- [X] Manager, Muni Dept.
- [ ] Underwriting
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- [ ] Operations
- [ ] Public Finance
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Suitability Recordkeeping for Institutional Accounts: Rule G-8

Amendment Approved

The technical amendment requires dealers to maintain records of suitability information for institutional accounts.

On February 7, 1989, the Securities and Exchange Commission approved a technical amendment to rule G-8(a)(xi), on recordkeeping of customer account information, that requires the recordkeeping of suitability information for institutional accounts.[1] The amendment became effective upon approval by the Commission.

Because of a cross-referencing problem in the rule, rule G-8(a) did not require dealers to keep suitability records for institutional accounts,[2] yet dealers are required to comply with rule G-19, on suitability of recommendations and transactions, when making recommendations to institutional customers. The amendment to rule G-8(a)(xi) corrects this cross-referencing problem and requires the recordkeeping of suitability information for institutional accounts.

February 7, 1989

Text of Amendment*

Rule G-8. Books and Records to be Made by Municipal Securities Brokers and Municipal Securities Dealers

(a) No change.

(i) through (x) No change.

(xi) *Customer Account Information*. A record for each customer, other than an institutional account, setting forth the following information to the extent applicable to such customer:

(A) through (K) No change.

For purposes of this subparagraph, the terms "general securities representative" and "general securities principal" shall mean such persons as so defined by the rules of a national securities exchange or registered securities association. For purposes of this subparagraph, the term "institutional account" shall mean the account of an investment company as defined in section 3(a) of the Investment Company Act of 1940, a bank, an insurance company, or any other institutional type account. Anything in this subparagraph to the contrary notwithstanding, every municipal securities broker and municipal securities dealer shall maintain a record of the information required by items (A), (C), (F), (H), (I) and (K) of this subparagraph with respect to each customer which is an institutional account.

(xii) through (xiv) No change.

Questions about this notice may be directed to Ronald W. Smith, Legal Assistant.

[1] SEC Release No. 34-26524.

[2] Rule G-8(a)(xi) states that "institutional account" means "the account of an investment company as defined in section 3(a) of the Investment Company Act of 1940, a bank, an insurance company, or any other institutional type account."

* Underlining indicates new language.

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Route to:

- [X] Manager, Muni Dept.
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- [ ] Trading
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- [ ] Operations
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- [ ] Training
- [ ] Other _____

Activities of Financial Advisors: Rule G-23

Questions and Answers

Answers to frequently asked questions concerning the ethical standards and disclosure requirements for dealers that act as financial advisors to municipal securities issuers.

This is a republication of a 1986 notice describing the requirements of rule G-23. Questions and answers on the application of the rule to dealers that may be related as affiliates or subsidiaries have been added.

FINANCIAL ADVISORY RELATIONSHIPS

Q: What is the intent of rule G-23 concerning the activities of financial advisors?

A: The intent of this rule is to establish disclosure requirements and standards for dealers that act as financial advisors to issuers of municipal securities.

Q: When is a dealer acting as a financial advisor?

A: A dealer advising an issuer with respect to the structure, timing, terms and other similar matters concerning a new issue or issues of municipal securities for a fee or other compensation or in expectation of such compensation is acting as a financial advisor.

Q: Is a dealer acting as a financial advisor for purposes of the rule when it structures a financing while acting as an underwriter on a negotiated issue?

A: No. A financial advisory relationship does not exist when, in the course of acting as an underwriter on a negotiated issue, a dealer advises an issuer, with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.

Q: Does the rule apply if a financial advisor acts as an agent for the issuer in placing the bonds?

A: The rule applies when a dealer, acting as a financial advisor to an issuer, wishes to "acquire as principal . . . from the issuer" the issue. However, if the financial advisor acts as agent for the purchase of the issue by a person controlling, controlled by, or under common control with the financial advisor, the rule would apply.

Q: Are all financial advisors subject to the rule?

A: The Board's rules apply only to financial advisors who are registered as brokers, dealers and municipal securities dealers with the SEC.

Q: Are financial advisory services provided to corporate obligors in connection with IDB financings subject to rule G-23?

A: No. Rule G-23 applies to dealers that agree to render financial advisory services to or on behalf of the "issuer."

Q: Must a financial advisory relationship be evidenced by a writing?

A: Yes. Each financial advisory relationship must be evidenced by a writing entered into prior to, upon, or promptly after the inception of the financial advisory relationship.

Q: Would financial advisory services furnished to a municipal district which has not yet been officially established at the inception of the relationship constitute financial advisory services for the purposes of the rule?

A: Yes. Paragraph (c) of the rule contemplates that the rule may apply even if the municipal issuer does not exist at the inception of the financial advisory relationship.

Q: If a dealer has an agreement with an issuer which provides that the dealer will furnish financial advisory services from time to time at the issuers request, does a financial advisory relationship exist with respect to a proposed new issue?

A: If a dealer has entered into a blanket agreement to render financial advisory services, a financial advisory relationship with respect to a particular new issue of securities will

be presumed to exist. Whether or not the dealer actually has a financial advisory relationship to the new issue is a factual question.

COMPENSATION

Q: Must the dealer and issuer enter into a written agreement regarding the dealer's compensation for its financial advisory services?

A: Yes. The agreement must state the basis of compensation for the financial advisory services, including provisions relating to the deposit of funds with or the utilization of fiduciary or agency services offered by such dealer.

Q: Is a financial advisory agreement which states that "the basis of compensation shall be a fee not to exceed X dollars" sufficient?

A: No. The dealer should specify the fees or commissions it is charging, not merely the highest possible amount of compensation it could receive.

Q: If a dealer provides financial advisory services for a fee and subsequently resigns to negotiate the issue, does the dealer have to reimburse the issuer for the fees received while acting as the financial advisor?

A: No. If the dealer received these fees for its services during the period it was acting as financial advisor for an issuer it may retain those fees.

UNDERWRITING ACTIVITIES

Q: May a financial advisor for a particular issue underwrite another issue for the same issuer without complying with the requirements of rule G-23(d)?

A: Yes. The rule applies only to a dealer that acts in both capacities with respect to a single issue of securities.

Q: Are there any restrictions on a financial advisor that wishes to underwrite a negotiated issue on which it is a financial advisor?

A: Yes. Rule G-23(d)(i) requires a financial advisor to:

(a) terminate the financial advisory relationship, in writing, and obtain the issuer's express consent to the dealer's participation in the underwriting;

(b) disclose in writing to the issuer that there may be a conflict of interest in changing from the capacity of financial advisor to underwriter and obtain the issuer's written receipt of such disclosure; and

(c) disclose to the issuer the source and anticipated amount of all remuneration to the dealer with respect to the issue in addition to compensation already received as the financial advisor and obtain the issuer's written receipt of such disclosure.

Q: When must a financial advisor obtain an issuer's consent permitting it to underwrite a negotiated sale?

A: The consent of the issuer must be obtained "at or after" the termination of the financial advisory relationship.

Q: May a financial advisor to an issuer for several issues terminate its financial advisory relationship with the issuer only with respect to a specific negotiated issue which it wishes to underwrite?

A: Yes. Under these circumstances, the advisory relationship may be terminated with respect to the specific negotiated issue.

Q: Must a dealer keep a record of all written agreements, disclosures, acknowledgements and consents?

A: Yes. Each dealer must maintain a copy of the written agreements, disclosures, acknowledgements and consents in a separate file and as required by rule G-9.

Q: What requirements must a financial advisor meet in order to bid on a competitive issue?

A: Rule G-23(d)(ii) requires the financial advisor to obtain the express written consent of the issuer prior to bidding on the issue.

Q: May a financial advisor obtain from the issuer prospective approval to participate in future competitive issues?

A: No. An issuer should have the opportunity to consider whether the financial advisor's potential conflict of interest is sufficient to warrant not consenting to its participation in the sale. The Board has concluded that an unrestricted consent would not afford an issuer such an opportunity and accordingly such blanket consent is not permitted.

Q: May a financial advisor reserve the right to bid on a competitive issue in the official statement or notice of sale?

A: No, since it is not clear that the issuer has a sufficient opportunity to determine whether it is in its best interest to allow its financial advisor to bid on the issue.

Q: Are there any restrictions on a financial advisor that wishes to purchase some of the bonds of an issue in the secondary market or as a member of a selling group?

A: A financial advisor is not precluded from purchasing such securities from an underwriter, either for its own trading account or for the account of customers, except to the extent that such purchase is made to contravene the purpose and intent of this rule.

Q: Do the restrictions in rule G-23(d) apply to a dealer wishing to act as underwriter for an issue if the dealer is a subsidiary or affiliate of another dealer that is acting as the financial advisor on the issue?

A: Yes. The limitations and requirements set forth in section

(d) apply to any dealer "controlling, controlled by, or under common control with" the dealer having a financial advisory relationship, irrespective of whether or not the two dealers are operating independently.

Q: In circumstances in which the control relationship between dealers is not obvious, how may one determine if rule G-23(d) applies? For example, if an individual is an officer of both dealers, but there is no corporate affiliation between the dealers, does a control relationship exist?

A: The existence of a control relationship is a question of fact to be determined from the entire situation. The SEC noted, for purposes of the Regulatory Flexibility Act, that a dealer would be deemed to be controlled by a person or entity who, among other things, has the ability to direct or cause the direction of the management or the policies of the dealer. In the above example, if the officer has the authority to direct the management or formulate the policies of both dealers, a control relationship may be found to exist.

Q: If a bank does not have a dealer department but acts as the financial advisor to the issuer, may its broker-dealer subsidiary underwrite the issue without complying with section (d)?

A: Rule G-23(d) applies only when the financial advisor and underwriter for an issue are the same dealer or are two dealers subject to a control relationship. Since the bank is not a dealer, Board rules do not apply. Disclosure by the dealer to the issuer of its affiliation with the bank, however, probably would be advisable.

Q: Would rule G-23(d) apply if a bank's dealer department wished to underwrite an issue when a non-broker-dealer subsidiary of the bank acted as financial advisor?

A: Again, rule G-23(d) applies only when the financial advisor and underwriter for the issue are the same dealer or are two dealers subject to a control relationship. However, we understand that the Office of the Comptroller of the Currency has required certain subsidiaries of national banks that are not broker-dealers but engage in financial advisory activities to comply with the requirements of rule G-23 before the bank dealer may act as underwriter on the issue because the potential for conflicts of interest still exists.

DISCLOSURE TO CUSTOMERS

Q: Does a dealer have to disclose his role as financial advisor of an issue of which it is an underwriter to a customer?

A: Yes. The dealer must disclose the financial advisory relationship in writing to each customer who purchased such securities from the dealer.

Q: When should a dealer acting as an underwriter make this disclosure?

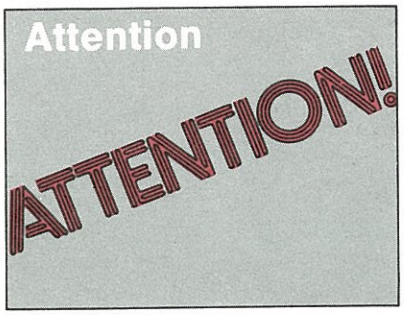
A: Disclosure must be made to the customer at or before completion of the transaction. Thus, the disclosure may be made in the official statement, the when-issued confirmation or in the final confirmation as long as the customer receives it before completion of the transaction.

APPLICABILITY OF STATE LAW

Q: Does the rule supersede a state law which prohibits financial advisors from serving as underwriters?

A: The rule specifically provides that it is not intended to supersede any more restrictive provisions of state or local law concerning the activities of financial advisors.

MSRB REPORTS
Volume 9, Number 1 March 1989



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Letter of Interpretation

Rules G-8, G-9 and G-27. Use of Electronic Signatures

This is in response to your letter and a number of subsequent telephone conversations regarding your dealer department's proposed use of a bond trading system. The system is an on-line, realtime system that integrates all front and back office functions. The system features screen input of customer account and trading information which would allow the dealer department to eliminate the paper documents currently in use. The signature of the representative introducing a customer account, required to be recorded with customer account information by rule G-8, and the signature of the principal signifying approval of each municipal securities transaction, required by rule G-27, would be performed electronically, *i.e.*, by input in a restricted data field. The signature of the principal approving the opening of the account, required by rule G-8, will continue to be performed manually on a printout of the customer information.[1]

Rule G-8(a)(vi) and (vii) require dealers to make and keep records for each agency and principal transaction. The records may be in the form of trading tickets or similar documents. In addition, rule G-8(a)(xi), on recordkeeping of customer account information, requires, among other things, the signature of the representative introducing the account and the principal indicating acceptance of the account to be included on the customer account record. Rule G-27(c)(ii) requires, among other things, the prompt review and written approval of each transaction in municipal securities. In addition, the rule requires the regular and frequent examination of customer accounts in which municipal securities transactions are effected in order to detect and prevent irregularities and abuses. The approvals and review must be made by the designated municipal securities principal or the municipal securities sales principal. Rule G-9(e), on preservation of records, allows records to be retained electronically provided that the dealer has adequate facilities for ready retrieval and inspection of any such record and for production of easily readable facsimile copies.

The Board recognizes that efficiencies would be obtained by the replacement of paper files with electronic data bases and filing systems and generally allows records to be retained in that form.[2] Moreover, as dealers increasingly automate, there will be more interest in deleting most physical records. Electronic trading tickets and automated customer account information satisfy the recordkeeping requirements of rule G-8 as long as such information is maintained in compliance with rule G-9(e).

The Board and your enforcement agency are concerned, however, that it may be difficult to verify a representative's signature on opening the account or a principal's signature approving municipal securities transactions or periodically reviewing customer accounts if the signatures are noted only electronically. Your enforcement agency has advised us of its discussions with you. Apparently, it is satisfied that appropriate security and audit procedures can be developed to permit the use of electronic signatures of representatives and principals and ensure that such signatures are verifiable. Thus, the Board has determined that rules G-8 and G-27 permit the use of electronic signatures when security and audit procedures are agreed upon by the dealer and its appropriate enforcement agency. Whatever procedures are agreed upon must be memorialized in the dealer's written supervisory procedures required by rule G-27.

MSRB Interpretation of February 27, 1989, by Diane G. Klinke, Deputy General Counsel.

[1] In addition, you noted in a telephone conversation that the periodic review of customer accounts required by rule G-27(c)(ii) also will be handled electronically using the principal's electronic signature to signify approval.

[2] *See* rule G-9(e).

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.
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