

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67064; File No. SR-MSRB-2012-05)

May 25, 2012

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Granting Approval of a Proposed Rule Change Consisting of a Restatement of an Interpretive Notice Concerning the Application of MSRB Rule G-17 to Sophisticated Municipal Market Professionals

I. Introduction

On March 26, 2012, the Municipal Securities Rulemaking Board (“Board” or “MSRB”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change consisting of a restatement of an interpretive notice (the current interpretive notice, “Existing SMMP Notice,” and the proposed restated interpretive notice, “Restated SMMP Notice”) concerning the application of MSRB Rule G-17 (on conduct of municipal securities and municipal advisory activities) to sophisticated municipal market professionals (“SMMPs”).³ The proposed rule change was published for comment in the Federal Register on April 13, 2012.⁴ The Commission received one comment letter on the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The implementation date for Financial Industry Regulatory Authority (“FINRA”) Rule 2111 (Suitability) is July 9, 2012. The MSRB proposed to adopt the same time frame for its Restated SMMP Notice.

⁴ See Securities Exchange Act Release No. 66772 (April 9, 2012), 77 FR 22367 (“Notice”).

change.⁵ On May 18, 2012, the MSRB submitted a response letter.⁶ This order approves the proposed rule change.

II. Description

Existing Definition of SMMP

Under the Existing SMMP Notice, a dealer is permitted to treat an institutional customer⁷ as an SMMP if the dealer has reasonable grounds for concluding the following and if other known facts do not contradict such a conclusion: (1) the customer has timely access to the publicly available material facts concerning a municipal securities transaction; (2) the customer is capable of independently evaluating the investment risk and market value of the municipal securities at issue; and (3) the customer is making independent decisions about its investments in municipal securities.⁸ The Existing SMMP Notice also provides additional considerations that may be relevant in determining whether an institutional customer has timely access to publicly available information, is capable of independently evaluating investment risk and market value, and is making independent investment decisions.

⁵ See letter to Elizabeth M. Murphy, Secretary, Commission, from David L. Cohen, Managing Director, Associate General Counsel, Securities Industry and Financial Markets Association, dated May 4, 2012 (“SIFMA Letter”).

⁶ See letter to Elizabeth M. Murphy, Secretary, Commission, from Ernesto A. Lanza, Deputy Executive Director and Chief Legal Officer, dated May 18, 2012 (“MSRB Letter”).

⁷ For purposes of the Existing SMMP Notice, an institutional customer is defined as “an entity, other than a natural person (corporation, partnership, trust, or otherwise), with total assets of at least \$100 million invested in municipal securities in the aggregate in its portfolio and/or under management.”

⁸ Although the Existing SMMP Notice permits a dealer to have an investor attest to SMMP status “as a means of streamlining the dealers’ process for determining that the customer is an SMMP,” it also provides that a dealer may not rely on such an attestation if the dealer knows or has reason to know that the investor lacks sophistication concerning a municipal securities transaction based on a number of factors set forth in the notice.

Application of Existing SMMP Definition

The Existing SMMP Notice addresses a dealer's obligations to an SMMP under MSRB's Rule G-17 (on fair dealing), Rule G-18 (on execution of transactions), Rule G-19 (on suitability), and Rule G-13 (on quotations). According to the MSRB, Rule G-17 requires brokers, dealers, and municipal securities dealers (collectively referred to herein as "dealers") to disclose to customers at or before the time of trade all material information about a transaction known by the dealer, as well as all material information about a security reasonably accessible to the market from established industry sources.⁹ The Existing SMMP Notice provides that, when a dealer effects a non-recommended secondary market transaction with an SMMP, its affirmative Rule G-17 disclosure duty concerning material information available from established industry sources will be deemed satisfied. A dealer, however, may not engage in deceptive, dishonest, or unfair practices under Rule G-17 or under the federal securities laws. Further, in a transaction with an SMMP, a dealer's intentional withholding of a material fact about a security when the information is not accessible through established industry sources may constitute an unfair practice that violates Rule G-17.

According to the MSRB, Rule G-18 provides that each dealer, when executing a transaction in municipal securities for or on behalf of a customer as agent, must make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions. The Existing SMMP Notice provides that a dealer effecting a non-recommended secondary market agency transaction for an SMMP is not required to take further actions to ensure that the transaction is effected at a fair and reasonable price, if its services have

⁹ See MSRB Interpretive Notice Regarding Rule G-17, On Disclosure of Material Facts (March 20, 2002) and MSRB Guidance On Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities (July 14, 2009).

been explicitly limited to providing anonymity, communication, order matching, and/or clearance functions and the dealer does not exercise discretion as to how or when a transaction is executed. The Existing SMMP Notice also states that this interpretation of Rule G-18 is particularly relevant to dealers operating alternative trading systems, as dealers operating such systems may be merely aggregating the buy and sell interest of other dealers or SMMPs.¹⁰ A footnote to the Existing SMMP Notice states that the same interpretation would apply to a broker's broker when executing an agency transaction for another dealer.

According to the MSRB, under Rule G-19, in the case of a recommended transaction, a dealer must have a reasonable basis for recommending a particular security ("reasonable-basis suitability"), as well as reasonable grounds for believing the recommendation is suitable for the customer to whom it is made, based upon information available from the issuer of the security or otherwise and based upon the facts disclosed by the customer or otherwise known about the customer ("customer-specific suitability"). The Existing SMMP Notice provides that, when a dealer has reasonable grounds for concluding that an institutional customer is an SMMP, the dealer's customer-specific suitability obligation is fulfilled.

According to the MSRB, under Rule G-13, no dealer may distribute or publish, or cause to be distributed or published, any quotation relating to municipal securities, unless the quotation is bona fide (i.e., the dealer making the quotation is prepared to execute at the quoted price) and the price stated in the quotation is based on the best judgment of the dealer of the fair market value of the securities that are the subject of the quotation at the time the quotation is made. In general, any quotation disseminated by a dealer (including the quotation of an investor) is

¹⁰ The Existing SMMP Notice also states that dealers operating alternative trading systems, under the general duty set forth in Rule G-18, must act to investigate any alleged pricing irregularities on its systems brought to its attention.

presumed to be a quotation made by the dealer, and the dealer is responsible for ensuring compliance with the bona fide and fair market value requirements with respect to the quotation. However, if a dealer disseminates a quotation that is actually made by another dealer and the quotation is labeled as such, then the quotation is presumed to be a quotation made by such other dealer and not by the disseminating dealer. In such a case, the disseminating dealer is only required to have no reason to believe that either: (1) the quotation does not represent a bona fide bid for, or offer of, municipal securities by the maker of the quotation; or (2) the price stated in the quotation is not based on the best judgment of the maker of the quotation of the fair market value of the securities. If a dealer disseminates the quotation of an SMMP and it is labeled as such, the disseminating dealer will be held to the same standard as if it were disseminating a quotation made by another dealer. The Existing SMMP Notice also provides several factors that are relevant to whether dissemination of the SMMP's quotation may be considered to be a violation of Rule G-13 by the dealer.

Considerations for Change

According to the MSRB, in 2002, it adopted a definition of SMMP that differed from certain other regulatory definitions of investors considered sophisticated enough to receive special treatment under federal securities law. The MSRB stated that the SMMP definition was closely modeled on an NASD interpretation of its suitability rule,¹¹ which contained a comparable list of factors found relevant to an investor's independent evaluation of risk and independent investment decisions. The MSRB stated that a notable difference was that the definition of SMMP also looked to whether the investor had access to material facts and that a key factor for the difference was the lack of information available about municipal securities at

¹¹ See NASD IM-2310-3 (Suitability Obligations to Institutional Customers).

that time. According to the MSRB, since the adoption of the existing definition of SMMP, there has been a vast increase in the availability of information about municipal securities reasonably accessible by institutional investors regardless of the amount of their holdings of municipal securities.

As of July 9, 2012, the NASD guidance on institutional suitability will no longer be in effect. It will be replaced by FINRA Rule 2111, which adopts a different approach to a FINRA member's customer-specific duty of suitability to an "institutional account." Under FINRA Rule 2111, a dealer's customer-specific suitability obligation to an institutional customer will be considered satisfied if (1) the dealer has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the dealer's recommendations. There will no longer be a detailed listing of factors, such as that found in the Existing SMMP Notice. The MSRB noted that, absent clear reasons for treating transactions in municipal securities differently, from the standpoint of reducing compliance cost, it generally considers it desirable to maintain consistency with FINRA rules.

Proposal to Restate SMMP Notice

Because the quality and availability of information concerning municipal securities has improved substantially since 2002, and to maintain consistency with the revised FINRA suitability rule for institutional customers, the MSRB proposed to retain the concept of an SMMP but revise its definition. Specifically, the MSRB proposed to define SMMP as an "institutional customer of a dealer that: (1) the dealer has a reasonable basis to believe is capable of evaluating investment risks and market value independently, both in general and with regard

to particular transactions in municipal securities, and (2) affirmatively indicates that it is exercising independent judgment in evaluating the recommendations of the dealer.”¹² The MSRB also proposed that “[a]s part of the reasonable basis analysis required by clause (1), the dealer should consider the amount and type of municipal securities owned or under management by the institutional customer.” There would no longer be a threshold requirement that a customer own or manage a certain amount of municipal securities in order to be considered an SMMP.

The MSRB proposed that, in the case of the affirmation described in clause (2) of the revised definition of SMMP, customers be allowed to make the affirmation orally or in writing and to provide the affirmation on a trade-by-trade basis, on a type-of-municipal-security basis, or for all potential transactions for the customer’s account. The MSRB stated that this requirement would be consistent with the affirmation requirement of FINRA Rule 2111, and receipt by a dealer of the FINRA 2111 affirmation would also satisfy this requirement.

The Restated SMMP Notice would not change the application of Rules G-18, G-19, and G-13 to SMMPs. However, it would change the application of Rule G-17 to SMMPs, under the assumption that institutional customers now have substantial access to material information about municipal securities. The Existing SMMP Notice excludes a dealer from the duty to disclose all material information available from established industry sources when it transacts a non-recommended transaction. The Restated SMMP Notice, however, would apply this

¹² “Institutional customer” would be defined as a customer with an “institutional account.” MSRB Rule G-8(a)(xi) defines “institutional account” as the account of (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (iii) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

exclusion to all transactions with SMMPs, whether recommended or self-directed. The Restated SMMP Notice would also remove the lists of factors to consider in determining a customer's status as an SMMP. In addition, the proposal would update the Existing SMMP Notice to reflect developments in the MSRB's interpretations of Rule G-17 since 2002. Further, the proposal would remove endnote 9 to the Existing SMMP Notice, which, according to the MSRB, has been construed by some to lessen the duty of a broker's broker under Rule G-18 in a manner that is inconsistent with the Board's proposed Rule G-43 (on broker's brokers).¹³ Lastly, the Restated SMMP Notice would remove the language that suggests that transactions on alternative trading systems are done on an agency basis, because, according to the MSRB, at least one major alternative trading system engages only in principal transactions.

III. Comments

The Commission received one comment letter supporting this proposed rule change.¹⁴ The commenter supported the revised definition of SMMP "as the quality and availability of information concerning municipal securities has greatly improved since 2002." The commenter agreed that it is desirable, from the standpoint of reducing the cost of dealer compliance, to maintain consistency with FINRA rules, absent clear reasons for treating transactions in municipal securities differently. Specifically, the commenter supported revising the definition of SMMP so that it is harmonized with FINRA's revised suitability rule as it applies to institutional customers. The commenter also expressed support for the "harmonized compliance regime to allow an institutional customer to provide a single affirmation of their desire to exercise

¹³ See Securities Exchange Act Release No. 66625 (March 20, 2012), 77 FR 17548 (March 26, 2012) (SR-MSRB-2012-04). The MSRB noted that, under proposed Rule G-43, an alternative trading system that had any customers (as defined in MSRB Rule D-9) that were not SMMPs would not be excepted from the definition of "broker's broker."

¹⁴ See SIFMA Letter, supra note 5.

independent judgment in selecting investments to satisfy FINRA Rule 2111 for all products, including the MSRB's requirement for SMMP status.” Further, to avoid confusion, this commenter supported the MSRB's proposal to implement the proposed rule change on July 9, 2012, the date on which FINRA Rule 2111 will become effective.

In its response letter,¹⁵ the MSRB acknowledged SIFMA's comment regarding harmonization with FINRA Rule 2111. It noted that in one respect, the revised definition of SMMP would be identical to the language of FINRA Rule 2111 – that both would refer to an institutional customer that affirmatively indicates that it is exercising independent judgment in evaluating the dealer's recommendations. As stated in the Notice, receipt by a dealer of the FINRA Rule 2111 affirmation would thus satisfy the second clause of the revised definition of SMMP. The MSRB however also noted that the other part of the revised definition of SMMP would provide that a dealer must have a reasonable basis to believe that an institutional customer is capable of evaluating investment risks and market value independently, both in general and with regard to particular transactions in municipal securities. Further, the MSRB noted that the Restated SMMP Notice would provide that, as part of the reasonable basis analysis, the dealer should consider the amount and type of municipal securities owned or under management by the institutional customer. The MSRB stated that FINRA Rule 2111 contains a similar, but not identical, requirement that “the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risk independently, both in general and with regard to particular transactions and investment strategies involving a security or securities.” The MSRB emphasized that “the language in the filing regarding the use of a FINRA Rule 2111 affirmation was not intended to suggest that a representation from an

¹⁵ See MSRB Letter, supra note 6.

institutional customer would, by itself, satisfy the dealer's reasonable basis obligation under the first prong of the revised SMMP definition.”

IV. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change, the comment letter received and the MSRB's response, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the MSRB.¹⁶ Specifically, the Commission finds that the proposed rule change is consistent with the provisions of Section 15B(b)(2)(C) of the Act,¹⁷ which requires, among other things, that the rules of the MSRB be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, obligated persons, and the public interest.

The Commission believes that the MSRB's proposal to restate its Existing SMMP Notice concerning the application of Rule G-17 to SMMPs is consistent with the Act. As noted by the MSRB, the amount of available information about municipal securities has substantially increased since the Existing SMMP Notice was approved, and this information is reasonably accessible by institutional investors regardless of the amount of their holdings of municipal

¹⁶ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁷ 15 U.S.C. 78o-4(b)(2)(C).

securities.¹⁸ For example, the MSRB's Electronic Municipal Market Access system ("EMMA") public website is a free on-line source for primary market disclosures, continuing disclosures, transaction data, variable rate security information, market statistics and investor education. Also, as noted by the MSRB, the Restated SMMP Notice would be consistent with FINRA's new rule on suitability obligations for an institutional account, which will be implemented on July 9, 2012. The Commission agrees with the MSRB that such consistency is desirable from the standpoint of reducing the cost of dealer compliance, absent clear reasons for treating transactions in municipal securities differently. The Commission, however, notes that under the Restated SMMP Notice, to meet the revised definition of an SMMP, a dealer must have a reasonable basis to believe the institutional customer is capable of evaluating investment risks and market value independently, both in general and with regard to particular transactions in municipal securities. As the MSRB has emphasized, a representation from an institutional customer would not, by itself, satisfy the dealer's reasonable basis obligation under this clause of the revised SMMP definition.

In light of the increase in access to material information about municipal securities, the Commission believes that it is consistent with the Act to expand the disclosure exclusion for material information to all transactions with SMMPs, whether recommended or self-directed. Accordingly, when a dealer has reasonable grounds for concluding that the customer is an SMMP, the dealer's obligation to ensure disclosure of material information available from

¹⁸ As noted above, although the Restated SMMP Notice would not require that an institutional customer own or manage a specified amount of municipal securities in order to fall within the definition of SMMP, the Restated SMMP Notice does provide that a dealer should consider the amount and type of municipal securities owned or under management by the institutional customer in establishing a reasonable basis to believe that the customer is capable of evaluating investment risks and market value independently.

established industry sources is fulfilled. In addition, the Commission believes that the proposal to amend the application of Rule G-17 to SMMPs to reflect developments in the MSRB's interpretations of Rule G-17 since 2002 is consistent with the Act, because it will help to ensure consistency between MSRB's rules. Further, the Commission believes that the proposal to remove endnote 9 to the Existing SMMP Notice is consistent with the Act, because it will help to clarify the duties of broker's brokers under MSRB rules. Lastly, the Commission believes that the proposal to remove the language that suggests that transactions on alternative trading systems are done on an agency basis is consistent with the Act, because it will help to ensure the accuracy of the Restated SMMP Notice. As noted above, according to the MSRB, at least one major alternative trading system engages only in principal transactions.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change (SR-MSRB-2012-05) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁰

Kevin M. O'Neill
Deputy Secretary

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).