G-30.[2] This Notice also applies previous guidance on bond insurance rating downgrades and wide-scale auction failures for municipal auction rate securities ("ARS") to municipal securities transactions in general and specifically to transactions with individual and other retail investors in variable rate demand obligations ("VRDOs").[3]

Basic Investor Protection Obligation

Rule G-17 is the core of the MSRB's investor protection rules. It provides that, in the conduct of its municipal securities activities, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. The rule contains an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 (the "Exchange Act"). However, it also establishes a general duty to deal fairly, even in the absence of fraud. This general duty to deal fairly places several specific obligations on dealers with respect to their dealings with their customers, including the obligation to disclose material information, described below. All activities of dealers must be viewed in light of these basic principles, regardless of whether other MSRB rules establish additional requirements on dealers.

Access to Material Information in the Municipal Securities Market

Many of the investor protection obligations established under MSRB rules are premised on dealer access to material information about municipal securities. Such access is fundamental not only to the ability of a dealer to meet its disclosure obligations to customers under MSRB rules but also to the ability of the dealer to undertake the necessary analyses to determine the suitability of a recommended municipal securities transaction and to determine the prevailing market price in connection with establishing a fair transaction price, among other things.

As professionals in the marketplace, dealers use a combination of internal resources and public and proprietary information sources to obtain the information necessary to conduct their business in a professional manner and to meet their disclosure and fair practice duties to investors. In 2002, the MSRB identified certain "established industry sources" in the municipal securities market that were available to and generally used by dealers that effect transactions in municipal securities.[4] While dealers and some institutional investors could readily access information from the established industry sources directly or through information vendors, most investors (and, in particular, individual investors) did not have ready access to many of the established industry sources and were largely limited to the information they could obtain through dealers.

With the advent of the MSRB's Electronic Municipal Market Access system ("EMMA") as a new established industry source, the amount, nature, timing and accessibility of information available to the entire marketplace, including both professionals and individual investors, has changed significantly since 2002. Official statements and other primary market disclosure documents, as well as continuing disclosure documents, are available to the general public through the EMMA web portal. Transaction price information is now available on a real-time basis, and comprehensive interest rate information for VRDOs and ARS also is available for the first time. All of this information is made available to the general public, at no cost, through the EMMA web portal, and also is available through subscription feeds to market participants and information vendors. It is expected that information vendors will continue to make this information available to their clients, together with increasing levels of value added products.

Disclosure of Material Information

General Disclosure Duty. Rule G-17 requires a dealer effecting a municipal securities transaction to disclose to its customer all material information about the transaction known by the dealer, as well as material information about the security that is reasonably accessible to the market.[5] Information available from established industry sources is deemed to be reasonably accessible to the market for purposes of this Rule G-17 disclosure obligation. Such disclosures must be made at or prior to the sale of municipal securities to the investor (*i.e.*, when the investor and the dealer agree to make the trade), also referred to as the "time of trade." This is a key protection mandated by MSRB rules.[6] This disclosure duty applies to any municipal securities transaction, regardless of whether the dealer is acting as a so-called "order-taker" (as when the trade is "unsolicited"), whether the transaction is recommended, or whether the transaction is a primary or secondary market trade.[7] Dealers continue to be obligated to make the required time of trade disclosures to their customers mandated by Rule G-17, notwithstanding the availability to investors of comprehensive information from EMMA and other established industry sources.

In general, information is considered "material" if there is a substantial likelihood that its disclosure would have been considered important or significant by a reasonable investor.[8] The duty to disclose material information to a customer in a municipal securities transaction includes the duty to give a complete description of the security, including a description of the features that likely would be considered significant by a reasonable investor and facts that are material to assessing the potential risks of the investment.[9] For VRDOs, ARS or other securities for which interest payments may fluctuate, such material facts would include a description of the basis on which periodic interest rate resets are determined.

The scope of material information that dealers are obligated to disclose to their customers under Rule G-17 is not limited solely to the information made available through established industry sources. Dealers also must disclose material information they know about the securities even if such information is not then available from established industry sources. It is es-

sential that dealers establish procedures reasonably designed to ensure that information known to the dealer is communicated internally or otherwise made available to relevant personnel in a manner reasonably designed to ensure compliance with this disclosure obligation.

Disclosures with Respect to Credit/Liquidity Enhancement and Ratings. The MSRB previously has provided guidance on specific disclosures that may be required in connection with insured municipal securities, including in particular insured ratings, underlying ratings and potential rating actions disclosed by the rating agencies.[10] The principles enunciated with respect to insured bonds also are generally applicable in connection with any third-party credit enhancement provided with respect to municipal securities, regardless of the type of such enhancement. This disclosure obligation extends to enhancements such as, without limitation, letters of credit, surety bonds, state or federal agency enhancements, and other similar products or programs.

For VRDOs, dealers generally must consider factors relevant to both the long-term nature of the securities as well as short-term liquidity features of such securities. Banks or other financial institutions (collectively, "banks") may issue letters of credit or similar product ("LOCs"), which provide both long-term credit support (by guaranteeing payment of principal and interest on VRDOs) and short-term liquidity support (by guaranteeing the purchase price of tendered VRDOs). Alternatively, banks may provide only liquidity support for tendered VRDOs, through a standby bond purchase agreement or similar product ("SBPA"). Typically, an SBPA is used when the issuer has a strong credit rating by itself or it is coupled with bond insurance. However, while LOCs are generally irrevocable for the term of the LOC, that is frequently not the case with SBPAs. Some SBPAs are structured so that certain negative credit or other events with regard to the issue or bond insurer result in the immediate termination of the SBPA and the loss of liquidity support, without a prior mandatory tender of the bonds.[11] If such an immediate termination event occurs, investors are left holding long-term, floating-rate bonds with no tender right.

The role of the remarketing agent also may be material to investors. If the remarketing agent for a VRDO has customarily or from time-to-time taken tendered bonds into inventory to make it unnecessary to draw on the liquidity facility for unremarketed bonds (thereby in effect providing liquidity support), the fact that the remarketing agent is not contractually obligated to maintain such practice will generally be material information required to be disclosed to customers to which VRDOs are sold.

The following information will generally be material information required to be disclosed to investors in credit/liquidity enhanced securities, including but not limited to VRDOs, if known to the dealer or if reasonably available from established industry sources: (i) the credit rating of the issue or lack thereof; (ii) the underlying credit rating or lack thereof; (iii) the identity of any credit enhancer or liquidity provider; and (iv) the credit rating of the credit provider and liquidity provider, including potential rating actions (*e.g.*, downgrade). Additionally, material terms of the credit facility or liquidity facility should be disclosed (*e.g.*, any circumstances under which an SBPA would terminate without a mandatory tender). This list is not exhaustive. Other information may also be material to investors in credit/liquidity enhanced securities.

Other Investor Protection Obligations

Although disclosure to investors is a key customer protection duty of dealers under MSRB rules, other important customer protection rules also apply. Thus, dealers are reminded that they are not relieved of their suitability obligations under MSRB Rule G-19 simply by disclosing material information to the customer. They are also not relieved of their fair pricing obligations to their customers under MSRB Rules G-18 and G-30 by disclosing material information to investors. The information known by a dealer in connection with a municipal security, together with the information available from established industry sources, generally should inform the dealer, to the extent applicable, in undertaking the necessary analyses and determinations needed to meet these other customer protection obligations.

Suitability of Recommendations. Under MSRB Rule G-19, a dealer that recommends a municipal securities transaction to a customer must have reasonable grounds for believing that the recommendation is suitable, based upon information available from the issuer of the security or otherwise (including from established industry sources) and the facts disclosed by or otherwise known about the customer.[12] To assure that a dealer effecting a recommended transaction with an individual investor has the information needed about the investor to make its suitability determination, the rule requires the dealer to make reasonable efforts to obtain information concerning the investor's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation.[13]

Dealers are reminded that the obligation arising under Rule G-19 in connection with a recommended transaction requires a meaningful analysis,[14] taking into consideration the information obtained about the investor and the security, which establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations are required regardless of the apparent safety of a particular security or issuer or the apparent wealth or sophistication of a particular investor. Suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, and those factors may vary from transaction to transaction. Factors to be considered include, but are not limited to, the investor's financial profile, tax status, investment objectives (including portfolio concentration/diversification), and the specific characteristics and risks of the municipal security recommended to the investor.

The MSRB notes that Section (c) of Exchange Act Rule 15c2-12 provides that it is impermissible for a dealer to recommend the purchase or sale of a municipal security unless the dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of the specified material events that are subject to the continuing disclosure obligations of the rule. A dealer would be expected to have reviewed any applicable continuing disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account in undertaking its suitability determination.

With regard to credit-enhanced securities, facts relating to the credit rating of the credit enhancer may affect suitability determinations, particularly for investors who have conveyed to the dealer investment objectives relating to credit quality of investments. For example, if a customer has expressed the desire to purchase only "triple A" rated securities, recommendations to the customer should take into account information from rating agencies, including information about potential rating actions that may affect the future "triple A" status of the issue. In the case of recommended VRDOs or any other securities that are viewed as providing significant liquidity to investors, a dealer must consider both the liquidity characteristics of the security and the investor's need for a liquid investment when making a suitability determination. Facts relating to the short-term credit rating, if any, of the LOC or SBPA provider, or of any other third-party liquidity facility provider, generally would affect suitability determinations in such securities. To the extent that an investor seeks to invest in VRDOs due to their liquidity characteristics, a suitability analysis also generally would require a dealer, in recommending a VRDO to an individual investor, to consider carefully the circumstances, if any, under which the liquidity feature may no longer be effectively available to the customer.

It is incumbent upon any dealer wishing to market municipal securities to customers that it understand the material features of the security, particularly if such dealer is to fulfill its obligation to undertake a suitability determination in connection with a recommended transaction. Dealers should take particular care with respect to new products that may be introduced into the municipal securities market,[15] existing products that may have complex structures that can differ materially from issue to issue, and outstanding securities that may trade infrequently, may be issued by less well-known issuers, or may have unusual features. Dealers are reminded that they must review the relevant disclosure documents to become familiar with the specific characteristics of the product, including the tax features, prior to recommending such products to their customers.

Fair Pricing. MSRB Rule G-30(a) establishes the pricing obligation of dealers in principal transactions between dealers and customers. The rule provides that the aggregate transaction price to the customer must be fair and reasonable, taking into consideration all relevant factors. A "fair and reasonable" price is one that bears a reasonable relationship to the prevailing market price of the security.[16] Dealers have a similar obligation with respect to the price of securities sold in agency transactions pursuant to Rule G-18. Dealer compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction, while compensation on an agency transaction generally consists of a commission. As part of the aggregate price to the customer, the mark-up or mark-down also must be fair and reasonable, taking into account all relevant factors.[17] Similarly, under Rule G-30(b), the commission on an agency transaction must be fair and reasonable, taking into account all relevant factors.

As a general matter, in addition to information about prices of transactions effected by such dealers and other market participants in such security, material information about a security available through EMMA or other established industry sources may also be among the relevant factors that the dealer should consider in connection with ensuring fair pricing of its transactions with investors. Among other things, dealers would be expected to have reviewed any applicable continuing disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account in determining a fair and reasonable transaction price. In addition, dealers should consider the effect of ratings on the value of the securities involved in customer transactions, and should specifically consider the effect of information from rating agencies, both with respect to actual or potential changes in the underlying rating of a security and with respect to actual or potential changes in the rating of any third-party credit enhancement applicable to the security.

Finally, many issuers currently include a retail order period in the marketing of new issues. The retail order period is intended to provide an opportunity for individual investors to place orders in advance of institutional investors. Dealers are reminded that an issuer's use of a retail order period based on a perception that the retail order period will improve pricing of the new issue for the issuer does not create a safe harbor for dealers to engage in pricing that violates the fair pricing obligation under Rule G-30. Large differences between institutional and individual prices that exceed the price/yield variance that normally applies to transactions of different sizes in the primary market provide evidence that the duty of fair pricing to individual clients may not have been met.

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1 *See Federal Reserve Flow of Funds*, Table L-211 (June 11, 2009) available at http://www.federalreserve.gov/releases/z1/Current/ (The household category in the Table reflects direct investments by individual investors, as well as investments by trusts, investment advisors, arbitrageurs, and various other accounts that do not fall into other tracked categories).

2 *See Reminder of Customer Protection Obligations in Connection With Sales of Municipal Securities*, MSRB Notice 2007-17 (May 30, 2007) (the "Fair Practice Notice"); *Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans*, MSRB Notice 2006-23 (August 7, 2006) (the "529 Notice").

3 *See Application of MSRB Rules to Transactions in Auction Rate Securities*, MSRB Notice 2008-09 (February 19, 2008) (the "ARS Notice"); *Bond Insurance Ratings Application of MSRB Rules*, MSRB Notice 2008-04 (January 22, 2008) (the "Bond Insurance Notice").

[4] *See* Rule G-17 Interpretation — Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, March 20, 2002, *reprinted in* MSRB Rule Book (the "2002 Disclosure Notice"). The 2002 Disclosure Notice described these established industry sources as including such sources as the system of nationally recognized municipal securities information repositories ("NRMSIRs") established by the SEC under Exchange Act Rule 15c2-12 for continuing disclosures by issuers and other obligors, the MSRB's Municipal Securities Information Library® (MSIL®) system for official statements and advance refunding documents, the MSRB's Transaction Reporting System for prices of transactions in municipal securities, rating agency reports, and other sources of information on municipal securities generally used by dealers that effect transactions in the type of securities at issue.

[5] *See* 2002 Disclosure Notice, *supra* n.5.

[6] Additional MSRB disclosure requirements under Rule G-15, relating to trade confirmations, and Rule G-32, relating to official statements, focus on information to be provided after the investment decision and do not fulfill the Rule G-17 disclosure obligation because they are not provided at or prior to the investment decision. Recent amendments to MSRB Rule G-32 in connection with electronic dissemination of official statements to investors purchasing municipal securities in a primary offering do not alter this time-of-trade disclosure obligation.

[7] A dealer's specific investor protection obligations, including its disclosure, fair practice and suitability obligations under Rules G-17 and G-19, may be affected by the status of an institutional investor as a Sophisticated Municipal Market Professional ("SMMP"). *See* Rule G-17 Interpretation — Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals, April 30, 2002, *reprinted in* MSRB Rule Book.

[8] *See* ARS Notice and Bond Insurance Notice; *see also Basic v. Levinson*, 485 U.S. 224 (1988). The SEC has described material facts as those "facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision." *Municipal Securities Disclosure,* Exchange Act Release No. 26100 (September 22, 1988) at note 76, quoting *In re Walston & Co. Inc., and Harrington*, Exchange Act Release No. 8165 (September 22, 1967).

[9] *See, e.g.*, Rule G-17 Interpretation — Educational Notice on Bonds Subject to "Detachable" Call Features, May 13, 1993, *reprinted in* MSRB Rule Book; Rule G-17 Interpretation — Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, March 4, 1986, *reprinted in* MSRB Rule Book.

[10] *See* Bond Insurance Notice, *supra* n.3.

[11] The termination of the SBPA may result in other changes to the terms of securities, such as the loss of any rights to tender the securities for purchase or an interest rate to be determined based on a floating rate index or in another manner, which may produce a yield that is substantially below market for a fixed rate bond of comparable maturity. Such facts may be material to investors.

[12] *See, e.g.*, Fair Practice Notice, *supra* n.2. The MSRB has previously stated that most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer, but determining whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances. *See* Rule G-19 Interpretive Letter — Recommendations, February 17, 1998, published in *MSRB Rule Book*. The MSRB also has provided guidance on recommendations in the context of on-line communications in Rule G-19 Interpretation — Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transactions, to Online Communications, September 25, 2002, published in *MSRB Rule Book*.

[13] Rule G-8(a)(xi)(F) requires that dealers maintain records for each customer of such information about the customer used in making recommendations to the customer.

[14] *See* 529 Notice n.2; Fair Practice Notice n.2; Bond Insurance Notice n.3.

[15] From time to time, the MSRB provides guidance on specific new products introduced into the municipal securities market. For example, the American Recovery and Reinvestment Act of 2009 authorized state and local governments to issue two types of Build America Bonds ("BABs") as taxable governmental bonds with federal subsidies for a portion of their borrowing costs. The MSRB has previously provided guidance to dealers regarding the application of MSRB rules to BABs, including fair practice rules. *See Build America Bonds and Other Tax Credit Bonds*, MSRB Notice 2009-15 (April 24, 2009); *Build America Bonds: Application of Rule G-37 to Solicitations of Issuers,* MSRB Notice 2009-30 (June 9, 2009). In addition, the MSRB has provided guidance on dealer transactions in registered warrants, or IOUs, issued by the State of California. *See Applicability of MSRB Rules to California Registered Warrants*, MSRB Notice 2009-41 (July 10, 2009). Nonetheless, dealers must understand the material features of any security they recommend, regardless of whether specific guidance is provided by the MSRB.

[16] *See Review of Dealer Pricing Responsibilities*, MSRB Notice 2004-3 (January 26, 2004) (the "Dealer Pricing Notice").

[17] Dealer Pricing Notice, *supra*.

Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities

September 29, 2009

The Municipal Securities Rulemaking Board ("MSRB") has recently provided guidance regarding the fair practice and related obligations of brokers, dealers and municipal securities dealers ("dealers") to investors.[1] Specifically, MSRB Rule G-17, on conduct of municipal securities activities, states that, in the conduct of its municipal securities business, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. The MSRB is publishing this notice to remind dealers that the fair practice requirements of Rule G-17 also apply to their municipal securities activities with issuers of municipal securities.

Thus, the rule requires dealers to deal fairly with issuers in connection with all aspects of the underwriting of their municipal securities, including representations regarding investors made by the dealer. As the MSRB has previously stated, whether or not an underwriter has dealt fairly with an issuer is dependent upon the facts and circumstances of an underwriting and cannot be addressed simply by virtue of the price of the issue.[2] The MSRB has also previously noted that Rule G-17 may apply in connection with certain payments made and expenses reimbursed during the municipal bond issuance process for excessive or lavish entertainment or travel expenses.[3]

As noted above, the fair practice requirements of Rule G-17 apply to all municipal securities activities of dealers with issuers. In particular, even where other MSRB rules provide for specific disclosures or other actions by, or establish specific standards of behavior for, dealers with respect to or on behalf of issuers, such disclosures, actions or behavior must also comport with the fair practice principles of Rule G-17. The MSRB will continue to review practices with respect to dealer activities with issuers.

[1] *See* MSRB Notice 2009-42 (July 14, 2009).

[2] *See* Rule G-17 Interpretive Letter — Purchase of new issue from issuer, *MSRB interpretation of December 1, 1997*, reprinted in *MSRB Rule Book*.

[3] *See* MSRB Rule G-20 Interpretation — Dealer payments in connection with the municipal securities issuance process, *MSRB interpretation of January 29, 2007*, reprinted in *MSRB Rule Book*.

MSRB Reminds Firms of Their Sales Practice and Due Diligence Obligations when Selling Municipal Securities in the Secondary Market

September 20, 2010

Executive Summary

Brokers, dealers and municipal securities dealers (dealers or firms) must fully understand the bonds they sell in order to meet their disclosure, suitability and pricing obligations under the rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws. These obligations are not limited to firms involved in primary offerings. Dealers must also obtain, analyze and disclose all material facts about secondary market transactions that are known to the dealer, or that are reasonably accessible to the market through established industry sources.

Those sources include, among other things, official statements, continuing disclosures, trade data, and other information made available through the MSRB's Electronic Municipal Market Access system (EMMA). Firms may also have a duty to obtain and disclose information that is not available through EMMA, if it is material and available through other public sources. The public availability of material information, through EMMA or otherwise, does not relieve a firm of its duty to disclose that information. Firms must also have reasonable grounds for determining that a recommendation is suitable based on information available from the issuer of the security or otherwise. Firms must also use this information to determine the prevailing market price of a security as the basis for establishing a fair price in a transaction with a customer. To meet these requirements, firms must perform an independent analysis of the bonds they sell, and may not rely solely on a bond's credit rating.

Continuing disclosures made by issuers to the MSRB via EMMA are part of the information that dealers must obtain, disclose and consider in meeting their regulatory obligations. The Securities and Exchange Commission (SEC) has recently approved amendments to Securities Exchange Act Rule 15c2-12, governing continuing disclosures. Firms that sell municipal securities should review and, if necessary, update their procedures to reflect the amendments, which have a compliance date of December 1, 2010.

Background and Discussion

MSRB Disclosure, Suitability and Pricing Rules

MSRB Rule G-17 provides that, in the conduct of its municipal securities activities, each dealer must deal fairly with all persons and may not engage in any deceptive, dishonest or unfair practice. The MSRB has interpreted Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale, all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.[1] This includes the obligation to give customers a complete description of the security, including a description of the features that likely would be considered significant by a reasonable investor and facts that are material to assessing the potential risks of the investment.

Such disclosures must be made at the "time of trade," which the MSRB defines as at or before the point at which the investor and the dealer agree to make the trade. Rule G-17 applies to all sales of municipal securities, whether or not a transaction was recommended by a broker-dealer.[2] This means that municipal securities dealers must disclose all information required to be disclosed by the rule even if the trade is self-directed.[3]

MSRB Rule G-19 requires that a dealer that recommends a municipal securities transaction have reasonable grounds for believing that the recommendation is suitable for the customer based upon information available from the issuer of the security or otherwise and the facts disclosed by, or otherwise known about, the customer.[4]

MSRB Rule G-30 requires that dealers trade with customers at prices that are fair and reasonable, taking into consideration all relevant factors.[5] The MSRB has stated that the concept of a "fair and reasonable" price includes the concept that the price must "bear a reasonable relationship to the prevailing market price of the security." The impetus for the MSRB's Real-time Transaction Reporting System (RTRS), which was implemented in January 2005, was to allow market participants to monitor market price levels on a real-time basis and thus assist them in identifying changes in market prices that may have been caused by news or market events.[6] The MSRB now makes the transaction data reported to RTRS available to the public through EMMA.

In meeting these disclosure, suitability and pricing obligations, firms must take into account all material information that is known to the firm or that is available through "established industry sources," including official statements, continuing disclosures, and trade data, much of which is now available through EMMA. Resources outside of EMMA may include press releases, research reports and other data provided by independent sources. Established industry sources can also include material event notices and other data filed with former nationally recognized municipal securities information repositories (NRMSIRs) before July 1, 2009.[7] Therefore, firms should review their policies and procedures for obtaining material information about the bonds they sell to make sure they are reasonably designed to access all material information that is available, whether through EMMA or other established industry sources. The MSRB has also noted that the fact that material information is publicly available through EMMA does not relieve a firm of its duty to specifically disclose it to the customer at the time of trade, or to consider it in

determining the suitability of a bond for a specific customer.[8] Importantly, the dealer may not simply direct the customer to EMMA to fulfill its time-of-trade disclosure obligations under Rule G-17.[9]

Amendments to Rule 15c2-12 Concerning Continuing Disclosure

Securities Exchange Act Rule 15c2-12 requires underwriters participating in municipal bond offerings that are subject to that rule[10] to receive, review, and distribute official statements of issuers of primary municipal securities offerings, and prohibits underwriters from purchasing or selling municipal securities covered by the rule unless they have first reasonably determined that the issuer or an obligated person[11] has contractually agreed to make certain continuing disclosures to the MSRB, including certain financial information and notice of certain events. The MSRB makes such disclosure public via EMMA.

Financial information to be disclosed under the rule consists of the following:

- Annual financial information updating the financial information in the official statement;
- Audited financial statements, if available and not included within the annual financial information; and
- Notices of failure to provide such financial information on a timely basis.

Currently, the rule enumerates the following as notice events, if material:

- Principal and interest payment delinquencies;
- Non-payment related defaults;
- Unscheduled draws on debt service reserves reflecting financial difficulties;
- Unscheduled draws on credit enhancements reflecting financial difficulties;
- Substitution of credit or liquidity providers or their failure to perform;
- Adverse tax opinions or events affecting the tax-exempt status of the security;
- Modifications to rights of security holders;
- Bond calls;
- Defeasances;
- Release, substitution or sale of property securing repayment of the securities; and
- Rating changes.

Rule 15c2-12(c) also prohibits any dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive prompt notice of any event notice reported pursuant to the rule. Firms should review any applicable continuing disclosures made available through EMMA and other established industry sources and take such disclosures into account in undertaking its suitability and pricing determinations.

On May 26, 2010, the SEC amended the rule's disclosure obligations, with a compliance date of December 1, 2010, to: (1) apply continuing disclosure requirements to new primary offerings of certain variable rate demand obligations (VRDOs); (2) add four new notice events;[12] (3) remove the materiality standard for certain notice events;[13] and (4) require that event notices be filed in a timely manner but no later than 10 business days after their occurrence. With respect to the tax status of the security, the rule has been broadened to require disclosure of adverse tax opinions, issuance by the IRS of proposed or final determinations of taxability and other material notices, and determinations or events affecting the tax status of the bonds (including a Notice of Proposed Issue). Firms that deal in municipal securities should familiarize themselves with these amendments, and, if necessary, modify their policies and procedures to incorporate this additional disclosure accordingly.

The Financial Industry Regulatory Authority (FINRA) noted in its Regulatory Notice 09-35 that, if a firm discovers through its Rule 15c2-12 procedures or otherwise that an issuer has failed to make filings required under its continuing disclosure agreements, the firm must take this information into consideration in meeting its disclosure obligations under MSRB Rule G-17 and in assessing the suitability of the issuer's bonds under MSRB Rule G-19.

Credit Ratings

In order to meet their obligations under MSRB Rules G-17 and G-19, firms must analyze and disclose to customers the risks associated with the bonds they sell, including, but not limited to, the bond's credit risk. A credit rating is a third-party opinion of the credit quality of a municipal security. While the MSRB generally considers credit ratings and rating changes to be material information for purposes of disclosure, suitability and pricing, they are only one factor to be considered, and dealers should not solely rely on credit ratings as a substitute for their own assessment of a bond's credit risk.[14] Moreover, different agencies use different quantitative and qualitative criteria and methodologies to determine their rating opinions. Dealers should familiarize themselves with the rating systems used by rating agencies in order to understand and assess the relevance of a particular rating to the firm's overall assessment of the bond.[15] With respect to credit or liquidity enhanced securities, the MSRB has stated that material information includes the following, if known to the dealer or if reasonably available from established industry sources: (i) the credit rating of the issue or lack thereof; (ii) the underlying credit rating or lack thereof, (iii) the identity of any credit enhancer or liquidity provider; and (iv) the credit rating of the credit provider and liquidity provider, including potential rating actions (*e.g.*, downgrade).[16] Additionally, material terms of the credit facility or liquidity facility should

be disclosed (*e.g.*, any circumstances under which a standby bond purchase agreement would terminate without a mandatory tender).

Other Material Information

In addition to a bond's credit quality, firms must obtain, analyze and disclose other material information about a bond, including but not limited to whether the bond may be redeemed prior to maturity in-whole, in-part or in extraordinary circumstances,[17] whether the bond has non-standard features that may affect price or yield calculations,[18] whether the bond was issued with original issue discount or has other features that would affect its tax status,[19] and other key features likely to be considered significant by a reasonable investor. For example, for VRDOs, auction rate securities or other securities for which interest payments may fluctuate, firms should explain to customers the basis on which periodic interest rate resets are determined.[20] The MSRB has stated that firms should take particular care with respect to new products that may be introduced into the municipal securities market, existing products that may have complex structures that can differ materially from issue to issue, and outstanding securities that may trade infrequently, may be issued by less well-known issuers, or may have unusual features.[21]

Supervision

Firms are reminded that MSRB Rule G-27 requires firms to supervise their municipal securities business, and to ensure that they have adequate policies and procedures in place for monitoring the effectiveness of their supervisory systems. Specifically, firms must:

- Supervise the conduct of the municipal securities activities of the firm and associated persons to ensure compliance with all MSRB rules, the Exchange Act and the rules thereunder;
- Have adequate written supervisory procedures; and
- Implement supervisory controls to ensure that their supervisory procedures are adequate.

Rule G-27 requires that a firm's supervisory procedures provide for the regular and frequent review and approval by a designated principal of customer accounts introduced or carried by the dealer in which transactions in municipal securities are effected, with such review being designed to ensure that transactions are in accordance with all applicable rules and to detect and prevent irregularities and abuses. Although the rule does not establish a specific procedure for ensuring compliance with the requirement to provide disclosures to customers pursuant to Rule G-17, firms should consider including in their procedures for reviewing accounts and transactions specific processes for documenting or otherwise ascertaining that such disclosures have been made.

Questions to Consider

Before selling any municipal bond, dealers should make sure that they fully understand the bonds they are selling in order to make adequate disclosure to customers under Rule G-17, to ensure that recommendations are suitable under Rule G-19, and to ensure that they are fairly priced under Rule G-30. Among other things, dealers should ask and be able to answer the following questions:

- What are the bond's key terms and features and structural characteristics, including but not limited to its issuer, source of funding (*e.g.*, general obligation or revenue bond), repayment priority, and scheduled repayment rate? (Much of this information will be in the Official Statement, which for many municipal bonds can be obtained by entering the CUSIP number in the MuniSearch box at www.emma.msrb.org.) Be aware, however, data in the Official Statement may have been superseded by the issuer's on-going disclosures.
- Does information available through EMMA or other established industry sources indicate that an issuer is delinquent in its material event notice and other continuing disclosure filings? Delinquencies should be viewed as a red flag.
- What other public material information about the bond or its issuer is available through established industry sources other than EMMA?
- What is the bond's rating? Has the issuer of the bond recently been downgraded? Has the issuer filed any recent default or other event notices, or has any other information become available through established industry sources that might call into question whether the published rating has been revised to take such event into consideration?
- Is the bond insured, or does it benefit from liquidity support, a letter of credit or is it otherwise supported by a third party? If so, check the credit rating of the bond insurer or other backing, and the bond's underlying rating (without third party support). If supported by a third party, review the terms and conditions under which the third party support may terminate.
- How is it priced? Be aware that the price of a bond can be priced above or below its par value for many reasons, including changes in the creditworthiness of a bond's issuer and a host of other factors, including prevailing interest rates.
- How and when will interest on the bond be paid? Most municipal bonds pay semiannually, but zero coupon municipal bonds pay all interest at the time the bond matures. Variable rate bonds typically will pay interest more frequently, usually on a monthly basis in variable amounts.

- What is the bond's tax status, under both state and federal laws? Is it subject to the Federal Alternate Minimum Tax? Is it fully taxable (*e.g.*, Build America Bonds)?
- What are its call provisions? Call provisions allow the issuer to retire the bond before it matures. How would a call affect expected future income?

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[1] MSRB Rule G-17 applies to all transactions in municipal securities, including those in both the primary and secondary market. MSRB Rule G-32 specifically addresses the delivery of the official statement in connection with primary offerings.

[2] *See* MSRB Notice 2009-42 (July 14, 2009).

[3] A dealer's specific investor protection obligations, including its disclosure, fair practice and suitability obligations under Rules G-17 and G-19, may be affected by the status of an institutional investor as a Sophisticated Municipal Market Professional ("SMMP"). *See* Rule G-17 Interpretation — Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals (April 30, 2002).

[4] *See* MSRB Notice 2009-42, *supra* n.2.

[5] Rule G-18 requires that a dealer effecting an agency trade with a customer make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.

[6] *See* MSRB Notice 2004-3 (January 26, 2004).

[7] Since July 1, 2009, material event notices are required to be filed through EMMA, which has replaced Bloomberg Municipal Repository; DPC DATA Inc.; Interactive Data Pricing and Reference Data, Inc.; and Standard & Poor's Securities Evaluations, Inc. as the sole NRMSIR.

[8] The MSRB has also stated that providing adequate disclosure does not relieve a firm of its suitability obligations. *See* MSRB Notice 2007-17 (March 30, 2007).

[9] Rule G-32 does allow a dealer to satisfy its obligation to deliver an official statement to its customer during the primary offering disclosure period no later than the settlement of the transaction by advising the customer of how to obtain it on EMMA, unless the customer requests a paper copy. The delivery obligation under Rule G-32 is distinct from the duty to disclose material information under Rule G-17, which applies to all primary and secondary market transactions.

[10] Certain limited offerings, variable rate demand obligations, and small issues are exempt from Rule 15c2-12.

[11] "Obligated person" is defined as "any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations of the municipal securities to be sold in the offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities)."

[12] The new notice events are (1) tender offers, (2) bankruptcy, insolvency, receivership, or similar events, (3) consummation of mergers, consolidations, acquisitions, or asset sales, or entry into or termination of a definitive agreement related to do the same, if material, and (4) appointment of a successor or additional trustee or a change in the name of the trustee, if material.

[13] The amendments removed the materiality standard and require notices for the following events: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances: and (6) rating changes. The amendments retained the materiality standard for the following events: (1) non-payment related defaults; (2) modifications to rights of security holders; (3) bond calls; and (4) release, substitution, or sale of property securing repayment of the securities.

[14] *See* MSRB Notice 2009-42, supra n.2. Ratings changes are reportable events under Rule 15c2-12.

[15] Not all municipal bonds are rated. While an absence of a credit rating is not, by itself, a determinant of low credit quality, it is a factor that the dealers should consider, and may warrant additional due diligence of the bond and its issuer by the dealer. In addition, MSRB Rule G-15 requires confirmation statements for customer trades in unrated municipal securities to disclose that the securities are not rated.

[16] *See* MSRB Notice 2009-42. The SEC has approved the MSRB's proposal to require dealers to submit copies of credit enhancement and liquidity facility documents to EMMA pursuant to amended MSRB Rule G-34(c), which may increase the availability of such information to dealers. *See* Securities Exchange Act Release No. 62755, August 20, 2010 (File No. SR-MSRB-2010-02).

[17] *See* Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, MSRB Interpretation of March 4, 1986.

[18] *See* Transactions in Municipal Securities With Non-Standard Features Affecting Price/Yield Calculations, MSRB Interpretation of June 12, 1995.

[19] *See* MSRB Notice 2005-01 (January 5, 2005); MSRB Notice 2009-41 (July 10, 2009).

[20] *See* MSRB Notice 2008-09 (February 19, 2008).

[21] *See* MSRB Notice 2009-42, *supra* n.2.

Interpretation on Priority of Orders for Securities in a Primary Offering under Rule G-17

October 12, 2010

On December 22, 1987, the MSRB published a notice[1] interpreting the fair practice principles of Rule G-17 as they apply to the priority of orders for new issue securities (the "1987 notice"). The MSRB wishes to update the guidance provided in the 1987 notice due to changes in the marketplace and subsequent amendments to Rule G-11.

Rule G-11(e) requires syndicates to establish priority provisions and, if such priority provisions may be changed, to specify the procedure for making changes. The rule also permits a syndicate to allow the syndicate manager, on a case-by-case basis, to allocate securities in a manner other than in accordance with the priority provisions if the syndicate manager determines in its discretion that it is in the best interests of the syndicate. Under Rule G-11(f), syndicate managers must furnish information, in writing, to the syndicate members about terms and conditions required by the issuer,[2] priority provisions and the ability of the syndicate manager to allocate away from the priority provisions, among other things. Syndicate members must promptly furnish this information, in writing, to others upon request. This requirement was adopted to allow prospective purchasers to frame their orders to the syndicate in a manner that would enhance their ability to obtain securities since the syndicate's allocation procedures would be known.

In addition to traditional priority provisions found in syndicate agreements, municipal securities underwriters frequently agree to other terms and conditions specified by the issuer of the securities relating to the distribution of the issuer's securities. Such provisions include, but are not limited to, requirements concerning retail order periods. MSRB Rule G-17

states that, in the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer ("dealer") shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. These requirements specifically apply to an underwriter's activities conducted with a municipal securities issuer, including any commitments that the underwriter makes regarding the distribution of the issuer's securities. An underwriter may violate the duty of fair dealing by making such commitments to the issuer and then failing to honor them. This could happen, for example, if an underwriter fails to accept, give priority to, or allocate to retail orders in conformance with the provisions agreed to in an undertaking to provide a retail order period. A dealer who wishes to allocate securities in a manner that is inconsistent with an issuer's requirements must not do so without the issuer's consent.

Except as otherwise provided in this notice, principles of fair dealing will require the syndicate manager to give priority to customer orders over orders for its own account, orders by other members of the syndicate for their own accounts, orders from persons controlling, controlled by, or under common control with any syndicate member ("affiliates") for their own accounts, or orders for their respective related accounts,[3] to the extent feasible and consistent with the orderly distribution of securities in a primary offering. This principle may affect a wide range of dealers and their related accounts given changes in organizational structures due to consolidations, acquisitions, and other corporate actions that have, in many cases, resulted in increasing numbers of dealers, and their related dealer accounts, becoming affiliated with one another.

Rule G-17 does not require the syndicate manager to accord greater priority to customer orders over orders submitted by non-syndicate dealers (including selling group members). However, prioritization of customer orders over orders of non-syndicate dealers may be necessary to honor terms and conditions agreed to with issuers, such as requirements relating to retail orders.

The MSRB understands that syndicate managers must balance a number of competing interests in allocating securities in a primary offering and must be able quickly to determine when it is appropriate to allocate away from the priority provisions, to the extent consistent with the issuer's requirements. Thus, Rule G-17 does not preclude the syndicate manager or managers from according equal or greater priority to orders by syndicate members for their own accounts, affiliates for their own accounts, or their respective related accounts if, on a case-by-case basis, the syndicate manager determines in its discretion that it is in the best interests of the syndicate. However, the syndicate manager shall have the burden of justifying that such allocation was in the best interests of the syndicate. Syndicate managers should ensure that all allocations, even those away from the priority provisions, are fair and reasonable and consistent with principles of fair dealing under Rule G-17.

It should be noted that all of the principles of fair dealing articulated in this notice extend to any underwriter of a primary offering, whether a sole underwriter, a syndicate manager, or a syndicate member.

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[1] MSRB Notice of Interpretation Concerning Priority of Orders for New Issue Securities: Rule G-17 (December 22, 1987).

[2] The requirements of Rule G-11(f) with respect to issuer requirements were adopted by the MSRB in 1998. *See* Exchange Act Release No. 40717 (November 27, 1998) (File No. SR-MSRB-97-15).

[3] "Related account" has the meaning set forth in Rule G-11(a)(xi).

Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities

August 2, 2012

Under Rule G-17 of the Municipal Securities Rulemaking Board (the "MSRB"), brokers, dealers, and municipal securities dealers ("dealers") must, in the conduct of their municipal securities activities, deal fairly with all persons and must not engage in any deceptive, dishonest, or unfair practice. This rule is most often cited in connection with duties owed by dealers to investors; however, it also applies to their interactions with other market participants, including municipal entities[1] such as states and their political subdivisions that are issuers of municipal securities ("issuers").

The MSRB has previously observed that Rule G-17 requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities.[2] More recently, with the passage of the Dodd-Frank Act,[3] the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MSRB is providing additional interpretive guidance that addresses how Rule G-17 applies to dealers acting in the capacity of underwriters in the municipal securities transactions described below. Except where a competitive underwriting is specifically mentioned, this notice applies to negotiated underwritings only. Furthermore, it does not apply to selling group members.

The examples discussed in this notice are illustrative only and are not meant to encompass all obligations of dealers to municipal entities under Rule G-17. The notice also does not address a dealer's duties when the dealer is serving as an advisor to a municipal entity. Furthermore, when municipal entities are customers[4] of dealers they are subject to the same protections under MSRB rules, including Rule G-17, that apply to other customers.[5] The MSRB notes that an underwriter has a duty of fair dealing to investors in addition to its duty of fair dealing to issuers. An underwriter also has a duty to comply with other MSRB rules as well as other federal and state securities laws.

Basic Fair Dealing Principle

As noted above, Rule G-17 precludes a dealer, in the conduct of its municipal securities activities, from engaging in any deceptive, dishonest, or unfair practice with any person,