Registration As Municipal Securities Dealer

Section 15B(a) of the Exchange Act makes it unlawful for any municipal securities dealer to use the mails or any instrumentality of interstate commerce to "effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security unless such municipal securities dealer is registered" with the Commission. Section 3(a)(30) of the Exchange Act defines "municipal securities dealer" to include a bank or a separately identifiable department or division of a bank if that bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise. Banks that engage solely in private placement activities in IDBs as described by you would not be required to register as municipal securities dealers since they do not appear to be engaged in the business of buying and selling municipal securities for their own accounts, but rather appear to be acting as brokers. Section 3(a)(4) of the Exchange Act defines the term broker as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Since they are excluded from the definition of broker, banks that act solely as brokers need not register under the Exchange Act.[4]

Inclusion In Separately Identifiable Department Or Division

Section 15B(b)(2)(H) of the Exchange Act authorizes the Municipal Securities Rulemaking Board (the "MSRB") to make rules defining the term "separately identifiable department or division" ("SID") of a bank as used in Section 3(a)(30) of the Exchange Act. MSRB rule G-1 defines the SID as "that unit of the bank which conducts all the activities of the bank relating to the conduct of business as a municipal securities dealer…" The rule defines municipal securities dealer activities to include "sales of municipal securities" and "financial advisory and consultant services for issuers in connection with the issuance of municipal securities." Therefore, those banks that have registered an SID with the Commission also must conduct the private placement activities within the SID in accordance with MSRB rules…

Based upon the facts and representations set forth in your letter, it would appear that the private placement activities of banks involving IDBs, as described in your example, constitute transactions in municipal securities that, if done alone, would not require a bank to register with the Commission as a municipal securities dealer. However, such activities, when conducted by a bank municipal securities dealer that had registered a separately identifiable department or division, would be treated as municipal securities dealer activities and, therefore, would be required to be conducted in the bank's dealer department…

[1] Rule G-23(b).

[2] You have represented that the IDBs involved would be primarily those defined in Section 103(b)(2) of the Internal Revenue Code of 1954 (the "Code"), the interest on which is tax-exempt under Sections 103(b)(4) and 103(b)(6) of the Code.

[3] This determination is based on an analysis of the specific facts as described by you. Different facts and circumstances could result in a transaction involving municipal debt instruments being treated as loan participations not subject to the federal securities laws. Such determinations can only be made on a case by case basis after a thorough examination of the context of the transaction.

[4] See letter dated February 17, 1977, from Anne E. Chafer, Attorney, Securities and Exchange Commission, to Bruce F. Golden and letter dated January 11, 1982, from Thomas G. Lovett, Attorney, Securities and Exchange Commission, to Harriet E. Munrett regarding Citytrust of Bridgeport, Connecticut.

Guidance on the Prohibition on Underwriting Issues of Municipal Securities for Which a Financial Advisory Relationship Exists Under Rule G-23

November 27, 2011

MSRB Rule G-23 establishes certain basic requirements applicable to a broker, dealer, or municipal securities dealer ("dealer") acting as a financial advisor with respect to the issuance of municipal securities. MSRB Rule G-23(d) provides that a dealer that has a financial advisory relationship with respect to the issuance of municipal securities is precluded from acquiring all or any portion of such issue, directly or indirectly, from the issuer as principal, either alone or as a participant in a syndicate or other similar account formed for that purpose. A dealer is also precluded from arranging the placement of an issue with respect to which it has a financial advisory relationship. This notice refers to both of these activities as "underwritings" and provides interpretive guidance on when a dealer may be precluded by Rule G-23(d) from underwriting an issue of municipal securities due to having served as financial advisor with respect to that issue. Rule G-23 is solely a conflicts rule. Accordingly, this notice does not address whether provision of the advice permitted by Rule G-23 would cause the dealer to be considered a "municipal advisor" under the Exchange Act and the rules promulgated thereunder.

Rule G-23(b) provides, among other things, that a financial advisory relationship shall be deemed to exist for purposes of Rule G-23 when a dealer renders or enters into an agreement to provide financial advisory or consultant services to or on behalf of an issuer with respect to the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such issue or issues. Rule G-23(b) also provides, however, that a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter and not as a financial advisor, a dealer provides advice to an issuer, including advice with respect to the structure, timing, terms, and other similar matters concerning the issuance of municipal securities.

Although Rule G-23(c) requires a financial advisory relationship to be evidenced by a writing, a financial advisory relationship will be deemed to exist whenever a dealer renders the types of advice provided for in Rule G-23(b), regardless of the existence of a written agreement. However, a dealer that clearly identifies itself in writing as an underwriter and not as a financial advisor from the earliest stages of its relationship with the issuer with respect to that issue (e.g., in a response to a request for proposals or in promotional materials provided to an issuer) will be considered to be "acting as an underwriter" under Rule G-23(b) with respect to that issue. The writing must make clear that the primary role of an underwriter is to purchase, or arrange for the placement of, securities in an arm's-length commercial transaction between the issuer and the underwriter and that the underwriter has financial and other interests that differ from those of the issuer. The dealer must not engage in a course of conduct that is inconsistent with an arm's-length relationship with the issuer in connection with such issue of municipal securities or the dealer will be deemed to be a financial advisor with respect to that issue and precluded from underwriting that issue by Rule G-23(d). Thus, a dealer providing advice to an issuer with respect to the issuance of municipal securities (including the structure, timing, and terms of the issue and other similar matters, when integrally related to the issue being underwritten) will not be viewed as a financial advisor for purposes of Rule G-23, if such advice is rendered in its capacity as underwriter for such issue. In addition to engaging in underwriting activities, it shall not be a violation of Rule G-23(d) for a dealer that states that it is acting as an underwriter with respect to the issuance of municipal securities to provide advice with respect to the investment of the proceeds of the issue, municipal derivatives integrally related to the issue, or other similar matters concerning the issue.

See also:

Rule D-12 Interpretation — Interpretation Relating to Sales of Municipal Fund Securities in the Primary Market, January 18, 2001.

Rule G-32 Interpretation — Notice Regarding Electronic Delivery and Receipt of Information by Brokers, Dealers and Municipal Securities Dealers, November 20, 1998.

Interpretive Letters

Financial advisory relationship: blanket agreement. I refer to your letter of December 4, 1980 and a subsequent conversation regarding the application of rule G-23(d) to the participation by your client, a municipal securities dealer, in the underwriting of securities to be issued by the County referred to in your letter (the "County").

Rule G-23(d) provides in pertinent part that no municipal securities dealer "that has a financial advisory relationship with respect to a new issue of municipal securities shall acquire as principal ... from the issuer all or any portion of such issue..." unless the dealer complies with certain specified provisions of the rule. You indicate that your client has a financial advisory agreement with the County which provides that your client will furnish financial advisory services from time to time at the County's request. You state, however, that your client was not requested to furnish financial advisory services with respect to the particular issue of securities which the County now proposes to sell and was selected by the County after responding to an advertisement for underwriters. You request our concurrence in your opinion that a financial advisory relationship with respect to the proposed new issue does not exist.

For purposes of the rule, a financial advisory relationship is deemed to exist when a "municipal securities dealer renders or *enters into an agreement to render* financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities ..." (emphasis added). Therefore, where a dealer has entered into a blanket agreement to render financial advisory services, a financial advisory relationship with respect to a particular issue of securities may be presumed to exist despite the fact that the municipal securities dealer does not furnish any financial advice concerning such issue. Whether or not your client has a financial advisory relationship with respect to the proposed new issue referred to in your letter is a factual question which we are not in a position to resolve. Therefore, we are unable to concur in your opinion. *MSRB interpretation of January 5, 1981.*

Financial advisory relationship: identity of issuer. This is in response to your letter of February 27, 1981, asking whether a dealer bank which is retained by the Board of Water Governors of a water utility owned by City X to provide advice regarding the structure, timing, and terms of a new issue of mortgage revenue bonds to be issued by City X has entered into a financial advisory agreement for purposes of rule G-23. You note that the bonds would be sold at a competitive underwriting and payable from the revenues of the water utility.

Under rule G-23, a financial advisory relationship is deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory services *to or on behalf of an issuer* with respect to a new issue or issues of municipal securities. Based solely upon the facts contained in your letter, it appears that the Board of Water Commissioners is a political subdivision of City X. It further appears that the Board of Water Governors entered into the financial advisory agreement for the specific purpose of obtaining advice regarding the new issue of bonds on behalf of the City. Thus, the fact that City X, rather than the Board of Water Governors, actually will issue the bonds would not itself support a conclusion that the financial advisory agreement is not subject to the provisions of rule G-23. *MSRB interpretation of March 13, 1981.*

Financial advisory relationship: mortgage-related services. This is in response to your letter of March 26, 1982 requesting an opinion regarding whether Board rule G-23 concerning the activities of financial advisors applies to certain activities of [name deleted] (the "Company").

Your letter states that the Company, a mortgage banker and wholly-owned subsidiary of [name deleted] (the "Bank"), identifies "proposed real estate development projects which it believes are economically feasible" and attempts to "arrange for the financing of such projects ..." You note that a common means of financing such projects involves the issuance and sale of tax-exempt obligations, with the proceeds of the sale being made available by the issuing entity to a mortgage approved by the Federal Housing Administration ("FHA"), which in turn provides financing secured by the FHA mortgage. You indicate that the services the Company performs in such instances include "... making the initial determination as to whether the contemplated project meets FHA criteria, negotiating with the developer regarding financing terms and conditions relating to the mortgage, contacting the issuer regarding its interest in issuing the bonds for the project, and, in certain cases where the issuer is not familiar or experienced in the area, assisting the issuer in understanding the rules and regulations of the FHA or the Development of Housing and Urban Development ..." You add that "the Company may also act as servicer of the construction loans which entails processing FHA insurance request forms, disbursing funds for completed work, etc." You state that "the Company does not provide financial advice to issuers regarding the structuring of the bond issues, or receive any fees, directly or indirectly, from issuers." You emphasize that any advice regarding the structuring of the actual bond issues is provided by the issuers' "staffs, financial advisors, bond counsel, or the underwriters of the issues." Your specific question concerns whether rule G-23 applies where the Company acts as mortgage banker and the Bank underwrites the bonds.

As you know, rule G-23(b) states that "... a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues for a fee or other compensation ..." Based upon the representations contained in your letter, it would appear that the Company does not render financial advisory services to issuers with respect to new issues of municipal securities. Since the activities which you state the Company performs in the ordinary course of its mortgage banking business do not constitute financial advisory activities for the purposes of rule G-23, the rule would not apply to those financings where the Bank serves as underwriter and the Company performs its mortgage banking functions, as described. *MSRB interpretation of April 12, 1982*.

Financial advisory relationship: potential underwriter. This responds to your letter of July 20, 1983, requesting our view on the applicability of Board rule G-23 to the following situation:

Your firm, a registered municipal securities dealer, along with an architectural firm and a construction firm, plans to present to a municipality a proposal to design, build and finance a criminal justice facility. If the municipality shows interest, the team members will suggest that the municipality engage them to put together a specific, customized proposal for review. If the municipality accepts this proposal, the team will ask the municipality to execute a contract covering the additional services. This contract will provide for compensation to be paid to the firm in connection with the creation of a financing proposal. This proposal could encompass such issues as those set forth in Rule G-23(b). Further, it is the intent of the team members that a project may ultimately be brought to fruition by all or any one of the team members. Therefore, the firm may make the final financing proposal but fail to be retained by the municipality to actually finance the construction. In this event, the other two team members will proceed and the municipality will obtain another underwriter. However, it will be the firm's intent throughout the negotiation phase to ultimately be retained as the municipality's underwriter.

You express concern whether the above facts create a financial advisory relationship under rule G-23(b). Board rule G-23(b), concerning activities of financial advisors, provides that a financial advisory relationship shall be deemed to exist:

> "when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, ..."

The rule provides, however, that a financial advisory relationship shall not be deemed to exist

> "when, *in the course of acting as an underwriter*, a municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities." [Emphasis added]

It does not appear that your firm would be rendering advice to the municipality "in the course of acting as an underwriter." In the beginning of the firm's relationship with the municipality, it is acting as a financial advisor, and being compensated as such. No underwriting agreement has been executed with the municipality. Therefore, based upon the representations in your letter, it appears that the firm's activities would be subject to the requirements of rule G-23. *MSRB interpretation of September 7, 1983*.

Financial advisory relationship: private placements. This is in response to your letter in which you seek clarification on certain matters related to rules G-23, on activities of financial advisors, and G-37, on political contributions and prohibitions on municipal securities business.

You ask when it is "necessary in the process of commencing preliminary work with a potential financial advisory client to enter into a formal written financial advisory contract." Rule G-23(c) states that "[e]ach financial advisory relationship

shall be evidenced by a writing entered into prior to, upon or promptly after the inception of the financial advisory relationship (or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences)." Rule G-23(b) states that "…a financial advisory relationship shall be deemed to exist when a broker, dealer or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services."

You ask whether you are to advise the Board by means of reporting on Form G-37/G-38 or by any other means when you commence work on subsequent financing transactions with an issuer with which your firm has an ongoing financial advisory contract. The Instructions for Completing and Filing Form G-37/G-38 provide a guideline to use in determining when to report financial advisory services on Form G 37/G 38.[1] Pursuant to these Instructions, dealers should indicate financial advisory services when an agreement is reached to provide the services. In addition, the Instructions note that dealers also should indicate financial advisory services during a reporting period when the settlement date for a new issue on which the dealer acted as financial advisor occurred during such period. There are no other requirements for reporting financial advisory services to the Board.

Finally, you ask whether rules G-23 or G-37 contain requirements concerning private placement activities. The term "municipal securities business" is defined in rule G-37 to include "the offer or sale of a primary offering of municipal securities on behalf of any issuer (*e.g.*, private placement)…" The Instructions for Completing and Filing Form G-37/G-38 provide that private placements should be indicated at least by the settlement date if within the reporting period.

With respect to rule G-23, section (d) of the rule states that no dealer that has a financial advisory relationship with respect to a new issue of municipal securities shall acquire as principal either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from the issuer all or any portion of such issue, or act as agent for the issuer in arranging the placement of such issue, unless various actions are taken.[2] In addition, rule G-23(g) states that each dealer subject to the provisions of sections (d), (e) or (f) of rule G-23 shall maintain a copy of the written disclosures, acknowledgments and consents required by these sections in a separate file and in accordance with the provisions of rule G-9, on preservation of records. Finally, rule G-23(h) states that, if a dealer acquires new issue municipal securities or participates in a syndicate or other account that acquires new issue municipal securities in accordance with section (d) of rule G-23, such dealer shall disclose the existence of the financial advisory relationship in writing to each customer who purchases such securities from such dealer, at or before the completion of the transaction with the customer. *MSRB interpretation of October 5, 1999.*

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[1] I have enclosed a copy of the Instructions for Completing and Filing Form G-37/G-38 as contained in the *MSRB Rule Book*. The Instructions are also contained on the Board's web site (www.msrb.org) under the link for rule G-37.

[2] These actions are: (i) if such issue is to be sold by the issuer on a negotiated basis, (A) the financial advisory relationship with respect to such issue has been terminated in writing and at or after such termination the issuer has expressly consented in writing to such acquisition or participation, as principal or agent, in the purchase of the securities on a negotiated basis; (B) the dealer has expressly disclosed in writing to the issuer at or before such termination that there may be a conflict of interest in changing from the capacity of financial advisor to purchaser of or placement agent for the securities with respect to which the financial advisory relationship exists and the issuer has expressly acknowledged in writing to the dealer receipt of such disclosure; and (C) the dealer has expressly disclosed in writing to the issuer at or before such termination the source and anticipated amount of all remuneration to the dealer with respect to such issue in addition to the compensation referred to in section (c) of rule G-23, and the issuer has expressly acknowledged in writing to the dealer receipt of such disclosure; or (ii) if such issue is to be sold by the issuer at competitive bid, the issuer has expressly consented in writing prior to the bid to such acquisition or participation.

Blanket consent. This is in response to your April 7, 1981, letter asking whether, consistent with rule G-23(d)(ii), a municipal securities dealer acting as a financial advisor to an issuer may obtain from the issuer prospective approval to participate in any and all new issues the issuer may sell on a competitive basis at some future date.

Rule G-23(d)(ii) provides that a municipal securities dealer which is acting as a financial advisor may not acquire or participate in the distribution of a new issue unless

> if such issue is to be sold by the issuer at competitive bid the issuer has consented in writing to such acquisition or participation.

The rule is designed to minimize the "prima facie" conflict of interest that exists when a municipal securities professional acts as both financial advisor and underwriter with respect to the same issue. Rule G-23(d) speaks in terms of "a new issue" and the implication is that consent should be obtained on an issue-by-issue basis.

The Board believes that such a reading of the rule is consistent with the rule's rationale — that an issuer should have an opportunity to consider whether, under the particular circumstances of an offering, 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, has determined that such a consent would not satisfy the requirements of rule G-23(d)(ii). *MSRB interpretation of July 30, 1981.*

Issuer consent: financial advisor participation in underwriting. This responds to your letter of March 6, 1984, regarding the application of rule G-23, concerning the activities of financial advisors to the following activities of [name deleted] (the "Company").

Your letter states that the Company serves as a financial advisor to a number of municipal entities with respect to the issuance and delivery of bonds. In the majority of circumstances in which bonds are to be marketed through a competitive bidding process, the Company is requested by the issuer either to bid for the bonds independently for its own account or as a participant with others in a syndicate organized to submit a bid. You state that the Company's customary financial advisory contract, in almost all instances, specifically reserves to the Company the right to bid independently or in a syndicate with others for any bonds marketed through a competitive bid.

However, to further accommodate these circumstances, you state that it is the Company's practice to include in the official statement on any bond issue subject to competitive bids specific language, such as:

> The Company is employed as Financial Advisor to the City in connection with the issuance of the Bonds. The Financial Advisor's fee for services rendered with respect to the sale of the Bond is contingent upon the issuance and delivery of the Bonds. The Company may submit a bid for the Bonds, either independently or as a member of a syndicate organized to submit a bid for the Bonds.

In the notice of sale, the following language is included:

> The Company, the City's Financial Advisor, reserves the right to bid on the Bonds.

You add that these two documents, the official statement and the notice of sale, must be approved by formal resolution of the governing authority of the issuer, such as a city council or a board of directors, before bids are requested or on the date of sale. You ask whether the above language printed in the official statement and the notice of sale, which is approved by formal resolution of the governing authority of the issuer, constitutes compliance with rule G-23(d)(ii).

Rule G-23, concerning the activities of financial advisors, is designed to minimize the *prima facie* conflict of interest that exists when a municipal securities professional acts as both financial advisor and underwriter with respect to the same issue. Specifically, rule G-23(d)(ii) provides that a municipal securities dealer which is acting as a financial advisor may not acquire or participate in the distribution of a new issue unless,

> if such issue is to be sold by the issuer at competitive bid, the issuer has expressly consented in writing prior to the bid to such acquisition or participation.

Compliance with the rule's requirement that an issuer expressly consent in writing to the financial advisor's participation in the underwriting cannot be inferred from its approval of the official statement and notice of sale. These documents are designed primarily to describe the new issue and a passing reference to the advisor's possible participation in the underwriting of the bond issue cannot be construed as express approval of such activity since it is not clear that the issuer is provided with a sufficient opportunity to determine whether it is in its best interests to allow its financial advisor to participate in the competitive bidding.

While the Board does not mandate the form of the issuer's consent, it understands that financial advisory contracts often may include consent language applicable to a specific new issue. Alternatively, financial advisors may obtain the consent of an issuer by means of a separate document. However, a financial advisory contract that reserves to the financial advisor the right to bid for any of the issuer's bonds marketed through a competitive bid does not satisfy the requirements of rule G-23(d)(ii). The Board has stated that such "blanket consents" do not afford an issuer a sufficient opportunity to consider whether, under the particular circumstances of an offering, the financial advisor's potential conflict of interest is sufficient to warrant not consenting to the financial advisor's participation in the sale. *MSRB interpretation of April 10, 1984.*

Fairness opinions. This is in response to your letter concerning the retention of your firm by issuers to render a fairness opinion on the pricing associated with certain negotiated issues of general obligation municipal securities issued by [state deleted] governmental units. You ask whether the rendering of these fairness opinions on the pricing of municipal securities issues is a financial advisory activity which must be disclosed on Form G-37/G-38 as municipal securities business.

Rule G-23, on activities of financial advisors, states in paragraph (b) that a financial advisory relationship shall be deemed to exist when

> a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, *including advice with respect to the* structure, timing, **terms** and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services. [Emphasis added]

Thus, the activity your firm performs on behalf of issuers of municipal securities pursuant to an agreement (*i.e.*, rendering advice with respect to the terms of a new issue) establishes that a financial advisory relationship exists between your firm and these issuers.

Rule G-37, on political contributions and prohibitions on municipal securities business, requires dealers to report municipal securities business to the Board on Form G-37/G-38. The definition of "municipal securities business" contained in rule G-37(g)(viii) includes

the provision of financial advisory or consultant services to or on behalf of an issuer with respect to a primary offering of municipal securities in which the dealer was chosen to provide such services on other than a competitive bid basis.

Pursuant to the information contained in your letter, your firm should submit a Form G-37/G-38 during each quarter in which the firm reaches an agreement to provide the financial advisory services you described. If your firm has an on-going financial advisory arrangement with an issuer, your firm would need to list each new issue in which your firm acted as financial advisor during the quarter in which the new issue settled. I have enclosed for your information a copy of the *Rule G-37 and Rule G-38 Handbook* which includes instructions for completing and filing Form G-37/G-38. *MSRB interpretation of January 10, 1997.*

See also:

Rule G-22 Interpretive Letter — Letters of credit, *MSRB interpretation of July 27, 1981.*

Rule G-23 Amendment History (since 2003)

Release No. 34-64564 (May 27, 2011), 76 FR 32248 (June 3, 2011); MSRB Notice 2011-29 (May 31, 2011)

Rule G-24
Use of Ownership Information Obtained in Fiduciary or Agency Capacity

No broker, dealer, or municipal securities dealer having access to confidential, non-public information concerning the ownership of municipal securities that was obtained by such broker, dealer, or municipal securities dealer (or by a bank or other person of which the broker, dealer, or municipal securities dealer is a department or division) in the course of acting in a fiduciary or agency capacity for an issuer of municipal securities or for another broker, dealer, or municipal securities dealer, including but not limited to acting as a paying agent, transfer agent, registrar, or indenture trustee for an issuer or as clearing agent, safekeeping agent, or correspondent of another broker, dealer, or municipal securities dealer, shall use such information for the purpose of soliciting purchases, sales, or exchanges of municipal securities or otherwise make use of such information for financial gain except with the consent of such issuer or such broker, dealer, or municipal securities dealer or the person on whose behalf the information was given.

Rule G-24 Interpretation

See:

Rule G-32 Interpretation — Notice Regarding Electronic Delivery and Receipt of Information by Brokers, Dealers and Municipal Securities Dealers, November 20, 1998.

Rule G-25
Improper Use of Assets

(a) *Improper Use*. No broker, dealer, or municipal securities dealer shall make improper use of municipal securities or funds held on behalf of another person.

(b) *Guaranties*. No broker, dealer, or municipal securities dealer shall guarantee or offer to guarantee a customer against loss in

(i) an account carried or introduced by such broker, dealer, or municipal securities dealer in which municipal securities are held or for which municipal securities are purchased, sold or exchanged or

(ii) a transaction in municipal securities with or for a customer.

Put options and repurchase agreements shall not be deemed to be guaranties against loss if their terms are provided in writing to the customer with or on the confirmation of the transaction and recorded in accordance with rule G-8(a)(v).

(c) *Sharing Account*. No broker, dealer, or municipal securities dealer shall share, directly or indirectly, in the profits or losses of

(i) an account of a customer carried or introduced by such broker, dealer, or municipal securities dealer in which municipal securities are held or for which municipal securities are purchased or sold or

(ii) a transaction in municipal securities with or for a customer.

Nothing herein contained shall be construed to prohibit an associated person of a broker, dealer, or municipal securities dealer from participating in his or her private capacity in an investment partnership or joint account, provided that such participation is solely in direct proportion to the financial contribution made by such person to the partnership or account.

Rule G-25 Interpretation

See:

Rule G-17 Interpretation — Notice Concerning the Application of Board Rules to Put Option Bonds, September 30, 1985.

Rule G-32 Interpretation — Notice Regarding Electronic Delivery and Receipt of Information by Brokers, Dealers and Municipal Securities Dealers, November 20, 1998.

Interpretive Letters

Letters of credit. This is in response to your letter dated August 1, 1980, requesting the Board's views on the application of rule G-25 to bank standby letters of credit issued in connection with new issues of securities which the dealer department of the bank intends to underwrite. Specifically, you have asked our views on whether such transactions would violate rule G-25(b), which generally prohibits a municipal securities dealer from guaranteeing a customer against loss in municipal securities transactions.

For the reasons discussed below, rule G-25(b) would not prohibit a municipal securities bank dealer from issuing a letter of credit which is publicly disclosed and for the benefit of all holders of the security.

Rule G-25(b) is an anti-manipulation rule which is primarily designed to prevent a municipal securities dealer from artificially stimulating the market in a security, for example, by "parking" it with a customer who has assumed no market risk. It does not appear that the issuance of a fully disclosed letter of credit provided by a bank dealer for the benefit of all bondholders could be used to serve a market manipulative purpose, even though the letter would also serve to protect the bank's own customers. Generally, such letters of credit protect bondholders from particular risks of loss, such as the inability of the issuer to make payments of principal or interest. Bondholders are not protected from general market risks, however, and, like all *bona fide* purchasers of securities, they incur gains or losses as the market price of the bonds fluctuates. Moreover, unlike the situation contemplated by rule G-25 which addresses guarantees made by dealers to their customers, the bondholders for whose benefit a letter of credit is issued would not necessarily have a customer relationship with the bank dealer issuing the letter. *MSRB interpretation of March 6, 1981.*

Indemnity agreement. This is in response to your letter dated March 18, 1981, regarding your client's (the "Bank") proposal to sell participations in industrial development bonds to one or more unit investment trusts or closed-end investment company (the "trust"), which bonds would be insured against default by the American Municipal Bond Assurance Corporation (AMBAC). Specifically you ask whether an agreement by the Bank to indemnify AMBAC to the extent of 25 percent of any losses suffered in the event of default would violate Board rule G-25(b) which generally prohibits a municipal securities dealer from guaranteeing a customer against loss in municipal securities transactions.

As you note in your letter, the Board has taken the position that a municipal securities bank dealer issuing a letter of credit which is publicly disclosed and for the benefit of all holders of the security would not violate the provisions of rule G-25(b). You state that the Bank's agreement to indemnify AMBAC would be disclosed to and, at least indirectly would be for the benefit, of all investors.

Based upon the facts contained in your letter, it appears that the proposed agreement would not be prohibited by rule G-25(b). *MSRB interpretation of March 26, 1981.*

Retroactive price adjustment for early redemption. This is in response to your letter dated January 15, 1986, regarding the application of Board rules to a plan to guarantee a minimum return to customers who purchase certain municipal securities. You note that many [state deleted] municipalities

issue General Obligation Temporary Notes with maturities of approximately one year. The municipalities also reserve the right to redeem at par any or all of the notes at any time prior to maturity. Historically, few notes are actually redeemed prior to their stated maturity.

You state that, acting as a municipal securities dealer, you desire to bid on these notes with the intent of selling them to your customers. The notes would be sold at a premium to generate trading profits. Because the notes can be redeemed by the issuer at any time at par, it is conceivable that someone who pays a premium for the notes could incur an actual return on their investment that is extremely small — even negative.

You ask whether, under Board rules, a municipal securities dealer may sell notes as described above, with the provision that if the notes are redeemed by the issuer prior to maturity, the dealer will adjust the original purchase price retroactively to provide a minimum return to the purchaser for the time held. The minimum return would be negotiated with the purchaser and confirmed in writing at the time of purchase from the dealer. You cite the following example:

> The XYZ Bank, a municipal securities dealer, purchases from the City of Anywhere, $100,000 par value of its 6% General Obligation Temporary Notes, dated 1-1-86, maturing 1-1-87 at par, redeemable at anytime at the option of the issuer.
>
> The XYZ Bank sells the notes to its customer, the ABC Bank, for settlement 1-1-86 to yield 5.75%. Can the XYZ bank agree that if the notes are redeemed prior to maturity by the issuer, it will adjust the original price at which the ABC Bank purchased the notes to provide a minimum return of at least 5% for the time held?

Board rule G-25(b) generally prohibits a municipal securities dealer from guaranteeing a customer against loss. Under the rule, put options and repurchase agreements are not deemed to be guarantees against loss if their terms are provided in writing to the customer with or on the confirmation of the transaction and recorded in accordance with rule G-8(a)(v). The rule is anti-manipulative in purpose and was designed, in part, to prevent a dealer from artificially stimulating the market in a security by selling securities to customers who assume no market risk. In addition, rule G-25(c) prohibits a municipal securities dealer from sharing, directly or indirectly, in the profits or losses of a transaction in municipal securities with or for a customer. Finally, rule G-30 requires municipal securities dealers to effect transactions with customers at fair and reasonable prices, taking into consideration, among other matters, the price of securities of comparable quality.

The arrangement you pose may be viewed as a guarantee against loss because the dealer would guarantee the customer a minimum return on his investment. In addition, the arrangement may be viewed as a sharing of loss arising from the customer's transaction because the dealer would participate in any loss sustained by the customer when it retroactively readjusts the price of the securities downward to grant the customer the promised return. Finally, rule G-30, on prices and commissions, requires that the price charged the customer for the securities at the time of sale, without taking into account any readjustment to the price at some future date, must be fair. *MSRB interpretation of January 31, 1986.*

Rule G-26
Customer Account Transfers

(a) *Definitions*. For purposes of this rule, the following terms have the following meanings:

(i) The term "delayed delivery asset" means an asset subject to a delayed delivery and includes when-issued securities.

(ii) The term "in-transfer asset" means an asset which has been submitted to the registrar or transfer agent for transfer and shipment to the customer at the time the transfer instruction is received by the carrying party.

(iii) The term "nontransferable asset" means an asset that is incapable of being transferred from the carrying party to the receiving party because it is:

(A) an issue in default for which the carrying party does not possess the proper denominations to effect delivery and no transfer agent is available to re-register the securities;

(B) a municipal fund security which the issuer requires to be held in an account carried by one or more specified brokers, dealers or municipal securities dealers that does not include the receiving party; or

(C) a proprietary product of the carrying party.

(iv) The term "participant in a registered clearing agency" shall mean a member of a registered clearing agency that is eligible to make use of the agency's automated customer securities account transfer capabilities.

(v) The term "registered clearing agency" shall be deemed to be a clearing agency as defined in, and registered in accordance with, the Exchange Act.

(vi) The term "safekeeping position" shall mean any security held by a carrying party in the name of the customer, including securities that are unendorsed or have a stock/bond power attached thereto.

(b) *Responsibility to Expedite Customer's Request*. When a customer whose municipal securities account is carried by a broker, dealer or municipal securities dealer (the "carrying party") wishes to transfer municipal securities account assets, in whole or in specifically designated part, to another broker, dealer or municipal securities dealer (the "receiving party") and gives authorized instructions to the receiving party, both parties must expedite and coordinate activities with respect to the transfer.

(c) *Transfer Instructions*.

(i) Parties may use Form G-26, the transfer instruction prescribed by the Board, or the transfer instructions required by a clearing agency registered with the Securities and Exchange Commission in connection with its automated customer account transfer system, or transfer instructions that are substantially similar to those required by such clearing agency, when accomplishing account transfers pursuant to this rule.

(ii) If an account, or an instruction to transfer specifically designated account assets, includes any nontransferable assets, the carrying party and/or the receiving party must provide the customer with a list of the specific assets and request, in writing and prior to or at the time of validation of the transfer instruction, further instructions from the customer with respect to the disposition of such assets. Such request shall provide the customer with the following alternative methods of disposition of nontransferable assets, if applicable:

(A) liquidation, with a specific indication of any redemption or other liquidation-related fees that may result from such liquidation (including a referral to the program disclosure or the registered representative for specific details regarding any such fees in the case of a nontransferable asset described in section (a)(iii)(B)), that those fees may be deducted from the money balance due the customer and that any remaining balance will be distributed to the customer, including the method by which it will be so distributed;

(B) retention by the carrying party for the customer's benefit;

(C) transfer, physically and directly, in the customer's name to the customer; or

(D) in the case of a nontransferable asset described in section (a)(iii)(B), transfer to another broker, dealer or municipal securities dealer, if any, which the issuer has specified as being permitted to carry such asset.

(iii) If the customer has authorized liquidation or transfer of assets deemed to be nontransferable, the carrying party must distribute the resulting money balance to the customer or initiate the transfer within five (5) business days following receipt of the customer's disposition instructions.

(d) *Transfer Procedures*.

(i) Upon receipt from the customer of an authorized transfer instruction to receive such customer's municipal securities account assets, in whole or in specifically designated part, from the carrying party, the receiving party must immediately submit such instruction to the carrying party. The carrying party must, within one business day following receipt of such instruction, validate and return the transfer instruction to the receiving party (with an attachment reflecting all positions and money balances as shown on its books) or take exception to the transfer instruction for reasons other than securities positions or money balance discrepancies and advise the receiving party of the exception taken.

(ii) The carrying party and the receiving party must promptly resolve any exceptions taken to the transfer instruction.

(e) *Validation of Transfer Instructions*.

(i) Upon validation of an instruction to transfer municipal securities account assets in whole, the carrying party must "freeze" the account to be transferred, *i.e.*, all open orders must be cancelled and no new orders may be taken.

(ii) Upon validation of an instruction to transfer municipal securities account assets, in whole or in specifically designated part, the carrying party must return the transfer instruction to the receiving party with an attachment indicating all municipal securities positions, safekeeping positions and any money balance to be transferred as shown on the books of the carrying party. Except as hereinafter provided, the attachment must include a then-current market value for all assets so indicated. If a then-current market value for an asset cannot be determined, the asset must be valued at original cost. However, delayed delivery assets, nontransferable assets, and assets in-transfer to the customer, need not be valued, although the "delayed delivery," "nontransferable," or "in-transfer" status of such assets, respectively, must be indicated on the attachment. A carrying party must provide the description set forth in Rule G-12(c)(v)(E) with respect to any municipal security that has not been assigned a CUSIP number in an account it is to transfer.

(iii) A carrying party may not take exception to a transfer instruction, and therefore deny validation of the transfer instruction, because of a dispute over municipal securities positions or the money balance in the account to be transferred. Such alleged discrepancies notwithstanding, the carrying party must transfer the municipal securities positions and/or money balance reflected on its books for the account.

(iv) A carrying party may take exception to a transfer instruction only if:

(A) it has no record of the account on its books;

(B) the transfer instruction is incomplete;

(C) the transfer instruction contains an improper signature;

(D) additional documentation is required (*e.g.*, legal documents such as death or marriage certificate);

(E) the account is "flat" and reflects no transferable assets;

(F) the account number is invalid (*i.e.*, the account number is not on the carrying party's books); however, if the carrying party has changed the account number for purposes of internally reassigning the account, it is the responsibility of the carrying party to track the changed account number, and such reassigned account number shall not be considered invalid for purposes of fulfilling a transfer instruction;

(G) it is a duplicate request;

(H) it violates the receiving party's credit policy;

(I) it contains unrecognized residual credit assets (the receiving party cannot identify the customer);

(J) the customer rescinds the instruction (*e.g.*, the customer has submitted a written request to cancel the transfer);

(K) there is a mismatch of the Social Security Number/Tax ID (*e.g.*, the number on the transfer instruction does not correspond to that on the carrying party's records);

(L) the account title on the transfer instruction does not match that on the carrying party's records;

(M) the account type on the transfer instruction does not correspond to that on the carrying party's records;

(N) the transfer instruction is missing or contains an improper authorization (*e.g.*, the transfer instruction requires an additional customer authorization or successor custodian's acceptance authorization or custodial approval; or

(O) the customer has taken possession of the assets in the account (*e.g.*, the municipal securities account assets in question have been transferred directly to the customer).

(v) If a carrying party takes exception to a transfer instruction because the account is "flat," as provided in paragraph (iv)(E) above, the receiving party may re-submit the transfer instruction only if the most recent customer statement is attached.

(vi) The carrying party and the receiving party must promptly resolve and reverse any nontransferable assets that were not properly identified during validation. In all cases, each party shall promptly update its records and bookkeeping systems and notify the customer of the action taken.

(vii) Upon receipt of the asset validation report, the receiving party shall designate any assets that are a product of a third party (*e.g.*, municipal fund security) with which the receiving party does not maintain the relationship or arrangement necessary to receive/carry the asset for the customer's account. The carrying party, upon receipt of such designation, may treat such designated assets as nontransferable and refrain from transferring the designated assets.

(viii) After validation of the transfer instruction by the carrying party, a receiving party may reject a transfer of municipal securities account assets in whole only if the account is not in compliance with the receiving party's credit policies or minimum asset requirements. A receiving party, however, may only reject the entire account for such reasons; it may not reject only a portion of the account assets (*e.g.*, the particular assets not in compliance with the party's credit policies or minimum asset requirement) while accepting the remainder.

(f) *Completion of the Transfer.*

(i) Within three business days following the validation of a transfer instruction, the carrying party must complete the transfer of the customer's municipal securities account assets to the receiving party. The receiving party and the car-