NASD NOTICE TO MEMBERS 94-32

SEC Chairman Endorses Periodic Training Of All Registered Personnel

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ■ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ■ Training

In 1993, the American Stock Exchange (Amex), the Chicago Board Options Exchange (CBOE), the Municipal Securities Rulemaking Board (MSRB), the National Association of Securities Dealers, Inc. (NASD), the New York Stock Exchange (NYSE), and the Philadelphia Stock Exchange (PHLX), endorsed the *Report and Recommendations of the Securities Industry Task Force on Continuing Education*. The Task Force report, which had input from the North American Securities Administrators Association (NASAA), called for a formal, two-part continuing education program for securities industry professionals that would require uniform training in regulatory matters and ongoing programs by firms to keep employees up-to-date on job-specific subjects.

The report also recommended creation of a permanent Industry/ Regulatory Council on Continuing Education (Council) to determine the specific content of the uniform regulatory component and to mandate specific minimum core curricula for inclusion in appropriate segments of ongoing firm-training programs. The Task Force recommended further that computer-based training be used as a primary vehicle for the uniform regulatory component of the program. The Council has met monthly in 1994 to define further the requirements of the continuing education program. It now expects to submit rule proposals to the self-regulatory organizations for publication and member comment in the summer of 1994.

The Honorable Arthur Levitt, Chairman of the Securities and Exchange Commission, has been very supportive of the Council's efforts and has expressed a strong interest in the rapid development of an effective program. He has met with the Council or its representatives on a number of occasions and has designated senior SEC staff members to work with the Council. Chairman Levitt also sent the following letter expressing his commitment to mandatory continuing education to the CEOs of members having the largest number of registered persons.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

To the Chief Executive Officer:

I am writing to you regarding an issue that I consider worthy of your attention and time: the continuing education of securities professionals. I believe we must proceed very quickly to develop and implement an industry-wide program that provides for the periodic training of all registered personnel. To realize this goal, it will be necessary for all firms to commit themselves to the development of a workable program.

In May 1993, the securities industry self-regulatory organizations (SROs) created a Task Force representing a cross-section of broker-dealer firms to study the issue of continuing education and develop recommendations. With the benefit of input from the SROs and the North American Securities Administrators Association, the Task Force issued its report in September 1993. To accommodate the divergent needs of individual firms, the Task Force's principal recommendation is to establish a program that has both a "Firm" and a "Regulatory" element. As proposed, the Firm element would mandate that each broker-dealer provide annual continuing education on its products and services to all its registered producing personnel who are in sales, trading, and investment banking, and their first line supervisors. The Regulatory element would require all registered personnel to receive training in compliance, regulatory, ethics and sales practice issues.

I urge you to take whatever steps necessary to ensure that your firm stays apprised of the work being pursued by the Industry/Regulatory Council on Continuing Education, the successor to the Task Force. You may obtain the report of the Task Force and more information about the timetable for implementation of a continuing education program by contacting William R. Simmons, Executive Vice President, Dean Witter Reynolds, Inc. at 212/392-3767; Ray Vass, First Vice President, Merrill Lynch, Pierce, Fenner & Smith, Inc. at 212/449-2539; or Ronald E. Buesinger, Corporate Secretary and Senior Vice President (retired), A.G. Edwards & Sons, Inc. at 314/289-3773.

I appreciate your involvement in and support of mandatory continuing education. Prompt implementation of this initiative should be one of the industry's highest priorities as it seeks to reinforce investor confidence in the U.S. capital markets through ensuring the highest level of integrity and competence among securities professionals.

Sincerely,

Arthur Levitt

NASD NOTICE TO MEMBERS 94-33

SEC Approves MSRB Rule G-19 Amendments

Suggested Routing

- [x] Senior Management
- [ ] Advertising
- [ ] Corporate Finance
- [ ] Government Securities
- [ ] Institutional
- [ ] Internal Audit
- [x] Legal & Compliance
- [x] Municipal
- [ ] Mutual Fund
- [x] Operations
- [ ] Options
- [ ] Registration
- [ ] Research
- [ ] Syndicate
- [ ] Systems
- [ ] Trading
- [x] Training

Executive Summary

On April 7, 1994, the Securities and Exchange Commission (SEC) approved amendments to Municipal Securities Rulemaking Board (MSRB) Rule G-19 concerning suitability of recommendations. The amendments eliminate two provisions that had operated as exemptions to the rule and clarify the information broker/dealers must obtain from customers as well as when it must be obtained. Finally, these changes revise the definition of "institutional account" contained in MSRB Rule G-8.

Background

Rule G-19 contains general standards for broker/dealers making recommendations to customers. Since adoption of these standards, the municipal securities market has seen an increase in the number of retail investors and the introduction of more complex, speculative municipal securities.

Responding to these developments and industry concerns for increased customer protection, the MSRB clarified and strengthened its rules governing what broker/dealers must ask customers and when recommendations are permissible.

Description Of Amendments

Under Rule G-19 a broker/dealer must determine that a proposed transaction is suitable for a customer before making any recommendations to the customer. The amendments to the rule eliminate two provisions that have been interpreted as exemptions from this requirement.

The first provision had permitted a broker/dealer to make a recommendation when a customer fails to provide sufficient personal information, on the customer's financial status or investment objective, as long as the broker/dealer has no reasonable grounds to believe that the recommendation is unsuitable. Now, a broker/ dealer lacking such specific information cannot make an investment recommendation to that customer.

The second deleted provision allowed broker/dealers to recommend specific municipal securities to investors who insisted on investing after being informed that, based on their financial circumstances, the investment would not be suitable. Eliminating this provision clarifies the circumstances under which broker/dealers may make recommendations to customers.

Additional amendments to Rule G-19 concern the information that must be obtained from customers. For non-institutional customers, the rule change clarifies that reasonable efforts must be made to obtain the customer's financial status, tax status, investment objectives, and other information the broker/dealer needs to make recommendations to the customer.

Although the amendment does not specify what must be requested from institutional accounts, the suitability rule itself applies equally to institutional and non-institutional accounts. The rule requires that for each recommendation of a municipal securities transaction, a broker/dealer shall have reasonable grounds, based upon information available from the issuer and facts disclosed by the customer or otherwise known about the customer, to believe that the recommendation is suitable.

Related Amendment To Rule G-8

At the same time, the MSRB revised the definition of "institutional

account" contained in Rule G-8 to include the accounts of savings and loan associations, investment advisers registered under Section 203 of the Investment Advisers Act of 1940, and other entities (e.g., a natural person, corporation, partnership, or trust) with total assets of at least $50 million. For purposes of suitability determinations, this change conforms the MSRB's definition of "institutional account" to the definition contained in Article III, Section 21(c)(4) of the NASD Rules of Fair Practice.

* * * * *

Questions concerning the Notice may be directed to Brad Darfler, District Coordinator, Compliance Department, (202) 728-8946.

NASD NOTICE TO MEMBERS 94-34

SEC Approves MSRB Rule G-37

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ■ Institutional
- ■ Internal Audit
- ■ Legal & Compliance
- ■ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ■ Syndicate
- ☐ Systems
- ☐ Trading
- ■ Training

Executive Summary

On April 13, 1994, the Securities and Exchange Commission (SEC) approved Municipal Securities Rulemaking Board (MSRB) Rule G-37 regarding political contributions and prohibitions on municipal securities business. Related amendments to Rules G-8 and G-9 on recordkeeping and record retention, respectively, were also approved. The limitations and requirements established by Rule G-37, and the changes to Rules G-8 and G-9, went into effect on April 25, 1994. Attached to this Notice is a *Special Notice To Selected Members* conducting a municipal securities business that was distributed April 18, 1994.

Background

MSRB Rule G-37 establishes several requirements affecting municipal securities broker/dealers, including limitations on business activities triggered by political contributions, limitations on soliciting or coordinating political contributions, and broker/dealer recordkeeping and disclosure.

The rule addresses practices known as "pay to play." These typically involve payments in the form of political contributions that help finance election campaigns for state or local officials. Widespread reports regarding the existence of these practices have prompted concern that they increase costs borne by issuers, dealers, and investors; create artificial barriers to competition; and undermine the integrity of the municipal securities market.

* * * * *

Members are urged to review the new rule in its entirety. Rule G-37, the amendment to Rules G-8 and G-9, background information, and a detailed discussion of industry comments were published in SEC Release No. 34-33868, which appeared in the April 13, 1994, *Federal Register*. A copy of the release follows this Notice.

Questions regarding this Notice may be directed to Walter J. Robertson, Director, Compliance Department (202) 728-8236, or Brad Darfler, District Coordinator (202) 728-8946.

SPECIAL NOTICE TO SELECTED MEMBERS

April 18, 1994

Dear Member:

On April 13, 1994, the Securities and Exchange Commission (SEC) approved Municipal Securities Rulemaking Board (MSRB) Rule G-37 regarding political contributions and prohibitions on municipal securities business. Related amendments to Rules G-8 and G-9 on recordkeeping and record retention, respectively, were also approved. The limitations and requirements established by Rule G-37, and the changes to Rules G-8 and G-9, are effective April 25, 1994.

MSRB Rule G-37 establishes several requirements affecting municipal securities broker-dealers, including limitations on business activities triggered by political contributions, limitations on soliciting or coordinating political contributions, and broker-dealer recordkeeping and disclosure.

Business Disqualification Provision

Rule G-37 prohibits municipal securities broker-dealers from engaging in municipal securities business with an issuer within two years after proscribed contributions made by (1) the broker-dealer, (2) any municipal finance professional associated with the broker-dealer, or (3) any political action committee (PAC) controlled by the broker-dealer or any such associated municipal finance professional, to an official of the issuer, who can, directly or indirectly, influence the awarding of municipal securities business.

Within the context of the rule, "municipal securities business" includes certain broker-dealer activities such as the purchase of a primary offering of municipal securities from the issuer on other than a competitive bid basis (i.e., acting as a managing underwriter or as a syndicate member in negotiated underwritings), and acting as a financial advisor, consultant, placement agent, or negotiated remarketing agent. The rule defines an "official of an issuer" as any incumbent, candidate (or successful candidate) for elective office of the issuer, which office is directly or indirectly responsible for, or can influence the outcome of, the hiring of a broker-dealer for municipal securities business. "Contributions" include any gift, subscription, loan, advance, or deposit of money or anything of value made:

(1) For the purpose of influencing any election of any official of a municipal securities issuer for federal, state, or local office;

(2) For payment or reduction of debt incurred in connection with any election; or

(3) For transition or inaugural expenses incurred by the successful candidate for state or local office.

The rule's disqualification provision also would be triggered by contributions from employees of broker-dealers referred to as "municipal finance professionals." The term "municipal finance professional" means:

(1) Any associated person primarily engaged in municipal securities representative activities, as defined in MSRB Rule G-3(a)(i);

(2) Any associated person who solicits municipal securities business;

(3) Any direct supervisor of such persons up through and including, in the case of a broker-dealer other than a bank dealer, the chief executive officer or similarly situated official, and, in the case of a bank dealer, the officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's municipal securities dealer activities, as required pursuant to Rule G-1(a); or

(4) Any member of the broker-dealer executive or management committee or similarly situated officials, if any (or, in the case of a bank dealer, similarly situated officials in the separately identifiable department or division of the bank, as defined in Rule G-1).

Family members are not specifically included within the definition of municipal finance professional. The rule, however, prohibits a broker-dealer and any municipal finance professional from doing any act indirectly that would result in a violation of the rule if done directly by the broker-dealer or municipal finance professional.

Moreover, the rule exempts contributions made by municipal finance professionals of $250 or less per election to each official for whom the individual is entitled to vote.

Solicitation Restriction

The rule also prohibits broker-dealers from soliciting contributions on behalf of officials of issuers with which the broker-dealer is engaging or seeking to engage in municipal

securities business. This will prevent broker-dealers from engaging in municipal securities business with issuers if they engage in any kind of fund-raising activities for officials of the issuers who may influence the underwriter selection process. This prohibition on solicitation and coordination also applies to municipal finance professionals. The rule prohibits municipal finance professionals from soliciting contributions to an official of an issuer with which the broker-dealer engages or is seeking to engage in municipal securities business and from coordinating contributions.

Disclosure And Recordkeeping

Rule G-37 requires broker-dealers to disclose to the MSRB on Form G-37 certain information about political contributions, as well as other summary information. Contributions to be reported include those to officials of issuers and political parties of states and political subdivisions made by the broker-dealer, any municipal finance professional, any executive officer, and any PAC controlled by the broker-dealer or by any municipal finance professional.

Broker-dealers also are required to disclose issuers with which the broker-dealer has engaged in municipal securities business during the reporting period, along with the type of municipal securities business and the name, company, role, and compensation arrangement of any person employed by the broker-dealer to obtain or retain municipal securities business from the issuers.

The reports must be submitted to the MSRB quarterly. The MSRB will include information reported on Form G-37 in its electronic library system, to allow for public access to the information. (Form G-37 will be provided to appropriate members by the MSRB shortly. At that time the reporting and due dates will also be announced.)

Rules G-8 And G-9

The amendment to Rule G-8 requires a dealer to maintain a list of:

(1) Names, titles, city/county, and state of residence of all associated municipal finance professionals;

(2) Names, titles, city/county, and state of residence of all executive officers of the broker-dealer;

(3) The states in which the broker-dealer is engaging or is seeking to engage in municipal securities business;

(4) Every issuer with which municipal securities business has been conducted during the current year, as well as the previous two years and, where applicable, the name, company, role, and compensation arrangement of any person employed by the broker-dealer to obtain or retain municipal securities business with the issuer; and

(5) All contributions, direct or indirect, to officials of issuers and to political parties of states and political subdivisions made by the broker-dealer, each dealer-controlled PAC, and each associated municipal finance professional and executive officer.

The rule does not require the broker-dealer to maintain a list of contributions by its municipal finance professionals or executive officers that are made:

(1) To officials for whom the person is entitled to vote, provided such contributions do not exceed $250 to each issuer official, per election; or

(2) To political parties for the state and political subdivision in which the person is entitled to vote, provided the contributions do not exceed $250 per party, per year.

The rule also does not require broker-dealers to maintain a list of contributions by any other employees, affiliate companies and their employees, spouses of covered employees, or any other person or entity unless the contributions were directed by persons or entities subject to Rule G-37.

The amendment to Rule G-9 requires broker-dealers to maintain, for a six-year period, those records required to be made pursuant to the amendment to Rule G-8. Such records must be kept for contributions made or business engaged in beginning April 25, 1994.

* * * *

Members are urged to review the new rule in its entirety. Rule G-37, the amendments to Rules G-8 and G-9, background information, and a detailed discussion of industry comments were published in SEC Release No. 34-33868, which appeared in the April 13, 1994, FEDERAL REGISTER.

Questions regarding this notice may be directed to Walter J. Robertson, Director, Compliance Department (202) 728-8236, or Brad Darfler, District Coordinator (202) 728-8946.

[Release No. 34-33868; File No. SR-MSRB-94-2]

Self-Regulatory Organization; Municipal Securities Rulemaking Board

April 7, 1994.

In the matter of Self-regulatory organizations; order approving proposed rule change by the Municipal Securities Rulemaking Board relating to political contributions and prohibitions on municipal securities business and notice of filing and order approving on an accelerated basis amendment No. 1 relating to the effective date and contribution date of the proposed rule.

On January 12, 1994, the Municipal Securities Rulemaking Board ("MSRB") submitted to the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-MSRB-94-02) pursuant to section 19(b)(1) of the Securities Exchange Act of 1934,[1] and Rule 19b-4 thereunder. The MSRB filed the proposal to adopt rules relating to political contributions and prohibitions on municipal securities business. The Commission published notice to the proposal in the **Federal Register** on January 21, 1994.[2] On February 4, 1994, the Commission extended the comment period for the proposal by 30 days, to March 11, 1994.[3] On March 29, 1994, the MSRB filed an Amendment to the proposal relating to the proposal's effective date and contribution date.[4]

The Commission received 69 comment letters on the proposed rule change. Twenty-four commentators favor the proposal and 33 oppose the proposal. Several commentators raise concerns without expressly favoring or opposing the proposal. Several commentators that favor the proposal make recommendations to better enable municipal securities dealers to comply with the proposal. The Commission has determined, for the reasons discussed below, to approve the proposed rule change.

I. Executive Summary

The MSRB's proposed rule change relating to political contributions and prohibitions on municipal securities business is intended to address practices known as "pay to play." These practices typically involve payments in the form of political contributions to help finance election campaigns of state or local officials or similar arrangements with these officials. Widespread reports regarding the existence of such practices has fueled industry and regulatory concerns. These practices directly affect municipal securities markets by increasing costs borne by issuers, dealers and ultimately investors, by creating artificial barriers to competition, and by undermining underwriter and market integrity. In 1993, state and local governments awarded negotiated underwriting contracts for the sale of more than $250 billion of municipal bonds, approximately 80% of all municipal securities underwritings, to facilitate the construction of schools, highways, hospitals, public housing, bridges, water and sewer systems, and other infrastructure projects needed to serve public needs and spur local and regional economic growth.[5] As of December 31, 1993, private investors, including households and mutual and money market funds, held more than $850 billion in municipal securities, representing approximately 70% of outstanding municipal securities.[6] While it is difficult to quantify the cost of fraudulent, unethical, and manipulative dealer selection practices, at a minimum, these practices substantially undermine the integrity of the municipal securities market. Congress recognized the importance of integrity in municipal securities financing when it directed the formation of the MSRB, as part of the Securities Acts Amendments of 1975, and authorized the MSRB to regulate the conduct of municipal securities dealers to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to free and open trade, and protect investors and the public interest.

As the self-regulatory organization ("SRO") charged with primary oversight of municipal securities dealers' activities, the MSRB has proposed a series of measures designed to prevent "pay to play" practices in the awarding of municipal securities business. These measures include a prohibition against municipal securities dealers, conducting certain types of municipal securities business with an issuer if the dealer or affiliated persons, subject to exceptions, made political contributions to officials of the issuer who could influence the awarding of that business. The measures also include separate provisions requiring municipal securities dealers to maintain records and to disclose aggregate information to facilitate compliance and examinations with the goal of promoting investor confidence in the integrity of the municipal securities market. As discussed below, the Commission believes that the proposal is consistent with the Act and will advance the goals of the Act.

II. Background

The market for municipal securities is characterized by great diversity and high volume and comprises an estimated 50,000 issuers including state governments, cities, towns, counties, and special subdivisions, such as special purpose districts and public authorities.[7] There are approximately 1.3 million municipal securities issues outstanding, representing over $1.2 trillion in securities.[8] In 1993, 17,000 new issues took place with a record value of $335 billion.[9] As discussed

[1] 15 U.S.C. 78s(b)(1).

[2] Securities Exchange Act Release No. 33482 (January 14, 1994), 59 FR 3389.

[3] Securities Exchange Act Release No. 33583 (February 4, 1994), 59 FR 6320.

[4] As originally submitted, the proposal's prohibitions on municipal securities business would arise from contributions made on or after April 1, 1994. The MSRB filed an amendment to change the April 1, 1994 date to a date 10 days after publication in the **Federal Register** of the Commission order approving the proposal. The MSRB also amended the proposal to change the effective date of the proposal's disclosure and recordkeeping requirements to a date 10 days after publication of the approval order in the **Federal Register**. File No. SE-MSRB-94-2, Amendment No. 1 (March 29, 1994).

[5] See Public Securities Association, *Review of Studies of Competitive and Negotiated Financing of Municipal and Corporate Securities* (March 1994).

[6] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Flows and Outstandings*, Fourth Quarter 1993 (March 9, 1994) ("Flow of Funds Accounts").

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

[8] See *Flow of Funds Accounts, supra* note 6.

[9] This record financing was heavily influenced by refundings. Nevertheless, the level of long term new money financing, representing 49% of the financing for the year, reflected continued market growth. In 1993, there were $142 billion of new money long term financings, compared to $81 billion in 1988, a 75% increase. "A decade of Municipal Finance," *The Bond Buyer* (Jan. 6, 1994) at 24. See also Securities Act Release No. 7049, Securities Exchange Act Release No. 33741 (March 9, 1994),

Continued

below, negotiated underwritings have become the predominate method of underwriter selection. The MSRB's proposal is designed to address abuses involving political contributions inherent in using negotiated underwriting as a method of underwriter selection.

A. Increasing Use of Negotiated Underwritings

The types of securities generally issued by municipalities include general obligation bonds (secured by the full faith and credit and general taxing power of the issuer), revenue bonds (secured by the revenues of a particular project), and conduit bonds (securities issued to finance a project that is to be used in the trade or business of a third party, typically a private corporation or non-profit entity). At one time general obligation bonds were most prevalent. Today, however, most offerings consist of revenue bonds. During the past few years, the municipal bond market also has experienced a proliferation of complex derivative products.[10]

Although competitive bidding traditionally has been used for public financing,[11] in recent years negotiated underwritings have become much more common.[12] in 1993, negotiated underwritings accounted for approximately 80% of all long-term municipal bond offerings.

Competitive bidding offers the public some protection against the exertion of inappropriate influence on public officials by municipal underwriters. When bidding is done competitively and publicly, there is less possibility of collusion and political patronage. Because the competitive process offers all potential bidders equal opportunity to be awarded the deal, bidders must compete with one another based on the pricing of the issue and the willingness to accept market risk.[13]

In contrast to competitive underwritings, negotiated underwritings present greater risk of abuse in the underwriter selection process.[14] Issuers may become involved not only in selecting the lead underwriter, but also in controlling other provisions of the distribution. Selection may be based on nonmeritorious considerations, creating a genuine risk that underwriters will be selected on the basis of political influence rather than the quality of the underwriter's services in distributing the securities.[15]

B. "Pay to Play"

Recent reports regarding "pay to play" have raised concerns about the practices municipal securities dealers employ to obtain municipal securities business. There have been numerous reported instances where registered municipal securities dealers, their employees, and related parties, allegedly have made payments, political contributions, or entered into business ventures with political figures apparently to obtain the underwriting business of municipal securities issuers. Specific abuses have been alleged in several state and local governments including Alabama,[16] California,[17] Colorado,[18] the District of Columbia,[19] Florida,[20] Illinois,[21] Kentucky,[22] Massachusetts,[23] Michigan,[24] New

59 FR 12748, and Securities Exchange Act Release No. 33742, (March 9, 1994), 59 FR 12759.

[10] Among these are principal and interest strips, pooled municipal investment vehicles, detachable call options, and new variable rate securities.

[11] At the time the Exchange Act was enacted, competitive bidding, in one form or another, was the most accepted method of financing used by municipalities and other public entities. L. Loss & J. Seligman, *Securities Regulation* 343 (1989). In competitive offerings, the issuer decides who will underwrite its bonds based almost entirely on price in response to the issuer's "notice of sale." Firms wishing to bid on an issue will include other firms in their syndicates based on their marketing or capital needs and the requirements of the issuer, if any. Some issuers will require the underwriting syndicate to include one or more firms with significant minority participation or specific regional capacity. This requirement usually is stated in the notice of sale. See MSRB, *Glossary of Municipal Terms*, (1985), definition of "competitive bid" or "competitive bidding."

[12] There can be an element of competition present in negotiated deals. In a negotiated offering, the issuer typically distributes a request for proposals ("RFP") to provide underwriting services for either a single issue, or more frequently, for a set period of years. Underwriters that are interested then submit their responses and the issuer will select one or more of the respondents to provide underwriting services. Issuers commonly select the entire management group in a negotiated offering, and often select most members of the selling group as well. Often an issuer will use the RFP process to "prequalify" a pool of underwriters as eligible to provide services and then select specific underwriters on a transaction by transaction basis. Consequently, the RFP process may not purge the selection process of undue influence. Notwithstanding the use of an RFP, issuers may award the municipal securities business according to existing non-merit based relationships with an underwriter.

In a large syndicate, one or more firms will serve as senior syndicate managers or co-managers; a second tier of firms will be designated as managers; the remaining syndicate members are the selling group. The issuer will also designate which of the managers will actually "run the books" and manage the syndicate. The senior managers and managers bear a risk of loss; members of the selling group do not bear this risk. Some issuers may select all the firms and delineate the position of each; others choose several firms as the management group, and give the senior syndicate managers discretion to choose members of the selling group (or name a few selling group members, and allow the senior managers to choose the remainder); still others will choose a senior manager and no others and the manager may or may not form a selling group.

[13] The Government Finance Officers Association ("GFOA") cites three advantages to competitive sales: assurance that the bonds are sold at the lowest cost in the prevailing market; lower gross underwriting spreads than negotiated sales, historically; and promotion of the appearance of an open, fair process. "Taxpayers have greater assurance that the bonds have been awarded at the lowest possible cost, and not for the benefit of underwriting firms engaged in political activities to support elected officials." *An Elected Official's Guide to Debt Issuance*, Kurish and Tigue, GFOA, Chicago, IL (1993) ("*Elected Official's Guide*").

[14] Negotiated sales do present advantages. GFOA notes three: ability to delegate tasks such as document preparation, sizing and structuring to the underwriter; pre-sale period in which structure may be tailored to investor demand; and flexibility to respond to market conditions. *Elected Official's Guide*. See also Public Securities Association, *Review of Studies of Competitive and Negotiated Financing of Municipal and Corporate Securities*, (March 1994).

[15] Regardless of whether an issue is competitive or negotiated, most issuers also employ financial advisers to assist in a bond offering. While some financial advisers are chosen on an issue by issue basis, others are retained to assist the issuer over a period of time. Financial advisers also are paid by the issuer, and their fees may be considered an expense of the offering.

[16] "Crying Cronyism, Lawmaker Seeks Alabama Ban on Negotiated Deals," *The Bond Buyer*, (February 7, 1994), at 1.

[17] "Curbs Sought on Bond Firm Contributions," *The Washington Post*, (January 14, 1994) at B2.

[18] "The Politics of Money," *U.S. News and World Report*, (September 20, 1993), at 67.

[19] "Lazard Pushed D.C. to Arrange Swaps With Merrill Lynch, D.C. Official Says," *The Bond Buyer*, (January 19, 1994), at 1; "Lazard Partner Says Firm Unaware of Ferber's Bid to Share D.C. Fees," *The Bond Buyer*, (January 20, 1994), at 1; "Cracking the 'Club' That Controls the Muni Bond Market," *The Washington Post*, (November 21, 1993), at H1.

[20] "The Bond Merchants: Wall Street Makes Millions on Municipal Bonds But Guess Who Pays?" *Common Cause Magazine*, (October 1993).

[21] "Chicago Confirms Being Subpoenaed by the Grand Jury in Ferber Inquiry," *The Bond Buyer*, (January 13, 1994), at 1; "Illinois Measure Would Restrict Campaign Giving by Bond Dealers," *The Bond Buyer*, (February 4, 1994), at 1; "Push to Curb Donations Not So Simple," *The Chicago Tribune*, (November 17, 1993), at 1.

[22] "At Trial, Kentucky's Bill Collins Gets Final Say as Prosecutors Hammer Away at the Gift Piano," *The Bond Buyer*, (October 11, 1993), at 1; "Kentucky Official Says He Served as Middleman to Solicit Funds." *The Bond Buyer*, September 7, 1993), at 1. Bill Collins is the husband of the former governor of Kentucky, Martha Layne Collins. On October 14, 1993, following a jury trial in the United States District Court for the Eastern District of Kentucky, he was convicted of extortion and conspiracy.

[23] "Treasurer's Office in Massachusetts Confirms Existence of Investigations," *The Bond Buyer*, (February 7, 1994), at 1; "Massachusetts Bars Merrill From Top Bond-Sale Role," *The Wall Street Journal*, (February 7, 1994), at C19; "Latest Accusations Leveled Against Ferber Provide New Details on 1990 MIFA Deal," *The Bond Buyer*, (December 21, 1993), at 1; "FEDs Subpoena MIFA For Second Time; Bond Documents Since 1982 Sought," *The Bond Buyer*, (January 27, 1994); "Papers Show New Links Between Ferber, Firm," *The Boston Globe*, (December 17, 1993), at 1.

[24] "Curbs Sought on Bond Firm Contributions," *The Washington Post*, (January 14, 1994), at B2.

Jersey,[25] New York,[26] Ohio,[27] Oklahoma,[28] and Wisconsin.[29] The widespread nature of the complaints concerning abuses has received considerable attention from Congress, the Commission, the MSRB, the securities industry, the media, and the public, reflecting concerns regarding the integrity, fairness, and sound operation of the municipal securities market.

C. Regulation of Municipal Securities Underwritings

It appears that "pay to play" practices are considered by many municipal securities dealers to be an ordinary cost associated with obtaining municipal underwriting business.[30] The widespread perception of such practices calls into question the integrity of the municipal securities market and the business practices some municipal underwriters utilize in order to obtain underwriting contracts. Several reports have suggested that the greatest cost of improper contributions is the cost to investors, taxpayers, and the public at large.[31]

As a result of reports alleging improper payments regarding the New Jersey Turnpike refunding, in May 1993, Congress requested the Commission, the MSRB, and the National Association of Securities Dealers ("NASD") to review the adequacy of regulation and oversight of the municipal securities market.[32]

This culminated in the Division's *Municipal Securities Report*,[33] and Congressional hearings on the municipal securities market held on September 9, 1993. The *Municipal Securities Report* recommended that "pay to play" contributions be addressed promptly.[34] The Staff stated that an MSRB proposal to require disclosure of political contributions and limiting campaign contributions for the purpose of obtaining underwriting business represented a positive first step to address the misuse of political contributions.[35]

The MSRB's efforts to examine the role of political contributions in the underwriting process pre-date recent public interest in the issue. In August 1991, the MSRB published a notice expressing concern that the process of selecting an underwriting team should not be influenced by political contributions, and encouraged underwriters, and state and local governments to maintain the integrity of the underwriter selection process.[36] In May 1993, the MSRB issued a press release noting continued concern by the MSRB, industry members, and others regarding political contributions.[37]

In August 1993, the MSRB published for comment draft rule G–37 ("August 1993 draft rule").[38] Although the majority of commentators supported the MSRB proposal, none gave unqualified support. After considering the commentators' concerns and suggestions at its November and December 1993 meetings, the MSRB proposed the instant rule change.

Some state officials and politicians have advocated or introduced legislation aimed at abuses resulting from political contributions and have made attempts to reform the municipal securities underwriter selection process.[39] Voluntary industry efforts also are underway to reduce the presence of inappropriate political influence peddling. On October 18, 1993, seventeen municipal securities dealers agreed to adopt a "Statement of Initiative," providing the political contributions made, in any manner, for the purpose of influencing the awarding of municipal finance business should be prohibited. To date, over 50 firms have agreed to adhere to the Statement of Initiative.[40]

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[25] "Lazard Freres, Merrill Lynch Fee Splitting Livens Debate," *The Bond Buyer*, (June 25, 1993), at 1; "New Jersey Turnpike, Merrill Lynch at Center of U.S. Attorney Probe," *The Bond Buyer*, (April 29, 1993), at 1; "N.J. Governor Bans Negotiated Underwriting at State Level," *The Bond Buyer*, (May 5, 1993), at 1; "Turnpike Officials Said Lazard Called the Shots," *The Bond Buyer*, (May 26, 1993), at 1; "Ferber Investigators Said to Pick Up Pace: Lazard Freres Subpoenaed, Others Wait," *The Bond Buyer*, (November 23, 1993), at 1.

[26] "Holtzman Dials Direct for Dollars, Asking Bankers to Help Pay Off Debt," *The Bond Buyer* (May 12, 1993), at 1; "Wall Street Executives Appear on List of Fund-Raiser for N.Y. Comptroller," *The Bond Buyer* (October 29, 1993), at 1; "Get Off McCall's Committee," *The Bond Buyer* (November 1, 1993), at 42; "NYC's Stein Urges Mayor, Comptroller to Copy New Jersey, Ban Negotiated Debt," *The Bond Buyer*, (May 12, 1993), at 1; "N.Y.C. Report Slams Holtzman For Negligence in Fleet Affair," *The Bond Buyer*, (September 16, 1993), at 1; "The Trouble With Consultants, The Market May be Getting Serious About Campaign Contributions, But There's More Ways to Peddle Influence," *The Bond Buyer*, (November 16, 1993), at 1; "Holtzman Says Loan Didn't Sway Choice of Fleet to Handle New York City Debt," *The Bond Buyer*, (April 26, 1993), at 1.

[27] "Armacon's Ohio Work a Smith Barney Favor After 1991 Lease Issue Soured in New Jersey," *The Bond Buyer*, (May 17, 1993), at 1.

[28] "Curbs Sought on Bond Firm Contributions," *The Washington Post*, (January 14, 1994), at B2; "SEC Investigates Oklahoma Issues for Possible Law Violations," *The Bond Buyer*, (November 23, 1993), at 1; "SEC Inspects Pike Bond Refinancing," *The Daily Oklahoman*, (November 19, 1993), at 1; "SEC Asks Agencies in Oklahoma for Data About Bond Issues," *The Wall Street Journal*, (November 24, 1993), at A5.

[29] "Curbs Sought on Bond Firm Contributions," *The Washington Post*, (January 14, 1994), at B2

[30] "Illegal Payments Mar the Muni Market," *The Wall Street Journal*, (May 5, 1993), at C1.

[31] "Bond Buyers' Gain, Taxpayers' Loss," *New York Times*, (September 5, 1993), at 11; "The Trouble With Munis, The Market is Sound, But Abuses Hurt Both Investors and Taxpayers," *Business Week*, (September 6, 1993), at 44.

[32] Letter from The Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, United States House of Representatives, and The Honorable Edward J. Markey, Chairman, Subcommittee on Energy and Commerce, United States House of Representatives, to Mary L. Schapiro, Acting Chairman, Commission, Christopher A. Taylor, Executive Director, MSRB, and Joseph R. Hardiman, President and Chief Executive officer, NASD (May 24, 1993).

[33] *Supra* note 7.

[34] The Commission's Chairman Arthur Levitt testified that, "[w]hile the Commission remains confident of the strength and effectiveness of the municipal securities market, we also share the Subcommittee's concern that investor confidence in its integrity may have been impaired as a result of recent serious allegations of abusive practices." Testimony of Arthur Levitt, Chairman, Commission, Concerning the State of the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (September 9, 1993).

[35] *Municipal Securities Report*, *supra* note 7, at 33.

[36] See MSRB Reports, Vol. 11, No. 3, (September 1991) at 11.

[37] See MSRB Reports, Vol. 13, No. 3, (June 1993) at 15.

[38] The draft proposal would have (1) prohibited brokers, dealers and municipal securities dealers and their associated persons from making political contributions directly or indirectly, to officials of issuers for the purpose of obtaining or retaining municipal securities business, and (2) required dealers and their associated persons to disclose, for a four-year period, all political contributions to officials of such issuers with whom they have done business.

[39] *E.g.*, House No. 1824, The Commonwealth of Massachusetts (a recently introduced bill to prohibit political contributions by investment bankers and bond counsel); The Commonwealth of Massachusetts Joint Statement on Debt Policy (issued to "[r]eaffirm and extend the statutory presumption that all Commonwealth Debt * * * shall be issued on a competitive, sealed-bid (lowest true interest cost) basis, and establish standards for rebutting that presumption * * *; [e]stablish a basic framework for the establishment of procurement processes for the selection of underwriters, financial advisors and attorneys * * *; [and] [f]urther the practice of requiring disclosure by underwriters, financial advisors and attorneys which fosters the elimination of conflicts of interest among those which serve the Commonwealth * * * in * * * issuances of debt."). The Commonwealth of Massachusetts Treasury Department (October 27, 1993).

See also "Crying Cronyism, Lawmaker Seeks Alabama Ban on Negotiated Deals," *The Bond Buyer*, (February 7, 1994), at 1; "Curbs Sought on Bond Firm Contributions," *The Washington Post*, (January 14, 1994), at B2; "Shapiro of Maine Seeks MSRB Ban on Political Contributions from Bond Firms," *The Bond Buyer*, (May 14, 1993), at 1; N.J. Governor Bans Negotiated Underwriting at State Level," *The Bond Buyer*, (May 5, 1993), at 1; "Following SEC, Texas Authority Seeks Disclosure on Political Gifts," *the Bond Buyer*, (June 23, 1993), at 1; "Massachusetts Bars Merrill From Top Bond-Sale Role," *The Wall Street Journal*, (February 7, 1994), at C19; "Municipal Bond Group Urges End To Being Solicited," *The Wall Street Journal*, (October 8, 1993), at C1.

[40] Some state and local officials have stated their intention to boycott those firms that voluntarily stop political contributions. The Florida

Continued

While the Commission views the voluntary efforts of those firms adhering to the Statement of Initiative as laudable, these actions represent only a first step. The MSRB's proposed rule change marks a second step: industry-wide reform intended to respond to the detrimental effects of conflicts of interest.

III. Description

The proposed rule change would establish industry-wide restrictions and requirements aimed at preventing fraudulent and manipulative practices, promoting just and equitable principles of trade, removing impediments to free and open trade, and protecting investors and the public interest. The MSRB's proposal is intended to address the real as well as perceived abuses resulting from "pay to play" practices in the municipal securities market. The proposal is a comprehensive scheme composed of several separated requirements affecting municipal securities dealers, including limitations on business activities triggered by political contributions, limitations on solicitation and coordination of political contributions, and dealer recordkeeping and disclosure.

A. Rule G–37—"Pay to Play" Restrictions

1. Business Disqualification Provision

Proposed rule G–37 will prohibit brokers, dealers and municipal securities dealers ("dealers") from engaging in municipal securities business with an issuer within two years after proscribed contributions made by (1) the dealer, (2) any municipal finance professional associated with the dealer, or (3) any political action committee ("PAC") controlled by the dealer or any such associated municipal finance professional, to an official of the issuer who can, directly or indirectly, influence the awarding of municipal securities business. "Municipal securities business" includes certain dealer activities such as the purchase of a primary offering of municipal securities from the issuer on other than a competitive bid basis (*i.e.* acting as a managing underwriter or as a syndicate member in negotiated underwritings), and acting as a financial advisor, consultant, placement agent, or negotiated remarketing agent.[41] The proposal defines an "official of an issuer" as any incumbent, candidate or successful candidate for elective office of the issuer, which office is directly or indirectly responsible for, or can influence the outcome of, the hiring of a dealer for municipal securities business. This includes any issuer official, incumbent or candidate (or successful candidate) who has influence over the awarding of municipal securities business. "Contributions" include any gift, subscription, loan, advance, or deposit of money or anything of value made: (1) For the purpose of influencing any election of any official of a municipal securities issuer for federal, state,[42] or local office; (2) for payment or reduction of debt incurred in connection with any election; or (3) for transition or inaugural expenses incurred by the successful candidate for state or local office.

Thus, contributions to certain state-wide executive or legislative officials will affect the eligibility of the firm to engage in municipal securities business.[43] The proposal applies to contributions made on or after April 25, 1994.[44]

The proposal's disqualification provision also would be triggered by contributions from employees of dealers, defined as "municipal finance professionals," are primarily engaged in municipal securities business. The proposal exempts contributions made by municipal finance professionals of $250 or less per election to each official for whom the individual is entitled to vote. The proposal defines the term "municipal finance professional" to mean:

(1) Any associated person primarily engaged in municipal securities representative activities, as defined in rule G–3(a)(i);[45]

(2) Any associated person who solicits municipal securities business;

(3) Any direct supervisor of such persons up through and including, in the case of a dealer other than a bank dealer, the chief executive officer or similarly situated official and, in the case of a bank dealer, the officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's municipal securities dealer activities, as required pursuant to rule G–1(a); or

(4) Any member of the dealer executive or management committee or similarly situated officials, if any (or, in the case of a bank dealer, similarly situated officials in the separately identifiable department or division of the bank, as defined in rule G–1).[46]

Family members are not specifically included within the definition of municipal finance professional. The proposal, however, prohibits a dealer and any municipal finance professional from doing any act indirectly which would result in a violation of the proposed rule if done directly by the dealer or municipal finance professional. This is intended to prevent dealers from funnelling funds or payments through other persons or entities to circumvent the proposal's requirements. For example, a dealer would violate the proposal if it does business with an issuer after contributions were made to an issuer official from or by associated persons, family members of associated persons, consultants, lobbyists, attorneys, other dealer affiliates, their employees or PACs, or other persons or entities as a means to circumvent the rule. A dealer also would violate the rule by doing business with an issuer after providing money to any person or entity when the dealer knows that the money will be given to an official of an issuer who could not receive the contribution directly from the dealer without triggering the rule's prohibition on business.

Association of Counties, for example, called for its members to boycott seventeen securities firms that have voluntarily banned political contributions citing these firms' endorsement of "public policy damaging rules." See "Politicians are Mobilizing to Derail Ban on Muni Underwriters' Campaign Gifts," *The Wall Street Journal*, (December 27, 1993), at C16.

[41] The proposed rule does not apply to competitive bids, *i.e.*, offerings in which the securities are awarded to the underwriting syndicate presenting the best bid according to stipulated criteria set forth in the notice of sale. See *Glossary of Municipal Terms, supra* note 11. Obviously, there is potential for abuse in determining the criteria by which eligibility is determined. If such abuse occurs, we would expect the MSRB to respond appropriately.

[42] The term "state" is defined in section 3(a)(16) of the Act to mean any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

[43] For example, governors will be included under the proposal's definition of official of an issuer.

[44] File No. SR–MSRB–94–2, Amendment No. 1 (March 29, 1994). See *supra* note 4.

[45] Rule G–3(a)(i) defines the term "municipal securities representative" as a person associated with a dealer, other than a person whose functions are solely clerical or ministerial, whose activities include one or more of the following: (A) Underwriting, trading or sales of municipal securities; (B) financial advisory or consultant services for issuers in connection with the issuance of municipal securities; (C) research or investment advice with respect to municipal securities; or (D) any other activities which involve communication, directly or indirectly, with public investors in municipal securities; provided, however, that the activities enumerated in subparagraphs (C) and (D) are limited to such activities as they relate to the activities enumerated in subparagraphs (A) and (B).

[46] The proposal's prohibition on business would result if a municipal finance professional associated with the dealer made the contribution before becoming associated with the dealer, (the two year ban on business applies to both the current and prior employer of the municipal finance professional).

The proposal will not restrict personal volunteer work by municipal finance professionals in political campaigns other than soliciting or coordinating contributions. However, if resources of the dealer are used or expenses are incurred by the municipal finance professional in personal volunteer work, the value of the resources or expenses must be included in determining whether the dealer is restricted from future negotiated underwritings involving that issuer or whether the municipal finance professional exceeded the $250 limitation.

2. Solicitation Restriction

The proposal also will prohibit dealers from soliciting contributions on behalf of officials of issuers with which the dealer is engaging or seeking to engage in municipal securities business.[47] This will prevent dealers from engaging in municipal securities business with issuers if they engage in any kind of fund-raising activities for officials of the issuers that may influence the underwriter selection process. This prohibition on solicitation and coordination also applies to municipal finance professionals. The proposal prohibits municipal finance professionals from soliciting contributions to an official of an issuer with which the dealer engages or is seeking to engage in municipal securities business and from coordinating contributions.

B. Disclosure and Recordkeeping

The proposal would establish disclosure and recordkeeping requirements to facilitate enforcement of rule G–37's "pay to play" restrictions and, independently, to function as a public disclosure mechanism to enhance the integrity of and public confidence in municipal securities underwritings. Thus, although the disclosure and recordkeeping provisions will generally supplement the "pay to play" restrictions, the purposes served by these provisions are distinct from, and not dependent on, the business disqualification or solicitation restriction provisions.

1. Rule G–37

Proposed rule G–37 will require dealers to disclose to the MSRB on Form G–37 certain information about political contributions, as well as other summary information, to facilitate public scrutiny of political contributions in the context of the municipal securities business of a dealer. Contributions to be reported include those to officials of issuers and political parties of states and political subdivisions made by the dealer, any municipal finance professional, any executive officer, and any PAC controlled by the dealer or by any municipal finance professional.[48] Only contributions over $250 by municipal finance professionals and executive officers are required to be disclosed. The proposal does not require dealers to disclose the names of individual municipal finance professionals and executive officers.

The proposal requires that dealers report on Form G–37 by state: (1) The name and title, (including any city/county/state or other political subdivision) of each official of an issuer and political party receiving contributions; (2) the total number and dollar amount of contributions made by the dealer, dealer controlled PACs, and associated municipal finance professionals, and (3) other identifying information as required by Form G–37. Dealers also will be required to disclose issuers with which the dealer has engaged in municipal securities business during the reporting period, along with the type of municipal securities business and the name, company, role and compensation arrangement of any person employed by the dealer to obtain or retain municipal securities business from the issuers. The reports are required to be made on Form G–37 and to be submitted to the MSRB in accordance with rule G–37 filing procedures, quarterly, by dates determined by the MSRB.

The MSRB will include information reported on Form G–37 in its electronic library system, the Municipal Securities Information Library ("MSIL"). The MSRB will develop appropriate filing procedures to allow for public access to the information, as well as indexing, and record storage.

2. Rules G–8 and G–9

The proposal will amend rules G–8 and G–9 on recordkeeping and record retention regarding political contributions. The proposed amendment to rule G–8 will require a dealer to maintain a list of: (1) Names, titles, city/county and state of residence of all associated municipal finance professionals; (2) names, titles, city/county and state of residence of all executive officers of the dealer; (3) the states in which the dealer is engaging or is seeking to engage in municipal securities business; (4) every issuer with which municipal securities business has been conducted during the current year, as well as the previous two years and, where applicable, the name, company, role and compensation arrangement of any person employed by the dealer to obtain or retain municipal securities business with the issuer; and (5) all contributions, direct or indirect, to officials of issuers and to political parties of states and political subdivisions made by the dealer, each dealer-controlled PAC, and each associated municipal finance professional and executive officer.[49] The records required pursuant to the proposal apply to contributions made or business engaged in beginning April 25, 1994.[50]

The proposal does not require the dealer to maintain a list of contributions by its municipal finance professionals or executive officers that are made: (1) To officials for whom the person is entitled to vote, provided such contributions do not exceed $250 to each issuer official, per election; or (2) to political parties for the state and political subdivision in which the person is entitled to vote, provided the contributions do not exceed $250 per party, per year. The proposal also does not require dealers to maintain a list of contributions by any other employees, affiliate companies and their employees, spouses of covered employees, or any other person or entity unless the contributions were directed by persons or entities subject to proposed rule G–37.

The proposed amendment to rule G–9 requires dealers to maintain, for a six-year period, those records required to be made pursuant to the proposed amendment to rule G–8.

IV. Summary of Comments

The Commission received 69 comment letters on the proposal. A separate summary of comments was prepared and is available in the public file. The Discussion section of this order addresses specific issues addressed by the commentators.

V. Discussion

The MSRB's rule proposal seeks to end "pay to play" abuses in municipal securities underwritings. The MSRB has

[47] The term "seeking to engage in municipal securities business" means dealer activities including responding to requests for proposals, making presentations of public finance capabilities, and other soliciting of business with issuer officials.

[48] The proposal does not require dealers to maintain a list of contributions by other employees, affiliated companies and their employees, spouses of municipal finance professionals, or any other person or entity unless the contributions were directed by persons or entities subject to the proposal.

[49] Dealers will be required to record, per contribution, the identity of the contributor and the recipient and the amount of the contribution.

[50] File No. SR–MSRB–94–2, Amendment No. 1 (March 29, 1994). See *supra* note 4.

determined that the most effective means of accomplishing this goal is through adoption of several provisions consisting, as described above, of a business disqualification provision, a solicitation restriction and disclosure and recordkeeping requirements. These provisions reflect well-established methods for dealing with conflicts of interest and other instances where improper influence is used to secure an unmerited benefit.

The Commission believes that the MSRB's proposal is tailored to accomplish its stated goals with minimal disruption in the municipal securities industry and the state and local political process to which that industry is linked. The Commission agrees with the MSRB that its proposal represents an appropriate response to a compelling problem and, therefore, has determined to approve the proposed rule change.

A. Statutory Standard

The proposed rule change is consistent with the requirements of the Act, and in particular, with sections 15B(b)(2) (C) and (G) of the Act.[51] Section 15B(b)(2)(C) authorizes the MSRB to adopt rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and, in general, to protect investors and the public interest. Section 15B(b)(2)(G) authorizes the MSRB to adopt rules that prescribe the records to be made and kept by municipal securities dealers and the periods for which such records shall be preserved. Because the MSRB's rules are to be preventive in nature, Section 15B defines the scope of the MSRB's authority in terms of purposes rather than subject matters. This authority provides the MSRB with flexibility to deal with future problems in the municipal securities industry.[52] Thus, Section 15B provides the MSRB broad rulemaking authority to implement its enumerated purposes.

1. Prevent Fraudulent and Manipulative Acts and Practices

The Commission and the MSRB have a significant interest in preventing fraudulent and manipulative acts and practices, as well as the appearance of fraud and manipulation, in the municipal securities market. One of the principal goals of Section 15B is to address threats to the integrity of the municipal securities market.[53] Underwriters perform essential functions in offerings by structuring the offering and preparing disclosure documents that form the basis of marketing the offering to the public.[54] If underwriter selection is swayed by political contributions or influence, underwriters may be chosen based on their history of contributions or political contacts, rather than their expertise or competence.

Several commentators contend that reports of abuse are unsubstantiated,[55] or view the issue as one of voter confidence and campaign reform, rather than investor protection.[56] The Commission believes, however, that "pay to play" practices may damage the municipal securities market in several ways. If political influence is the determinative factor in the choice of municipal securities dealers as underwriters in an offering, the underwriter selected may be less likely or competent to perform a reasonable investigation of statements made by the issuer in connection with the offering.[57] A decrease in the credit quality of the issue after it has been sold could have a significant adverse impact on investors, and the underwriter's investigation might reveal information that bears directly on the issuer's future ability to meet interest and principal payment obligations on a timely basis.

"Pay to play" also undermines the integrity of municipal securities underwriting. The mere perception of political influence in underwriter selection diminishes investor confidence in an underwriter's willingness to faithfully fulfill its obligations to the investing public. The Statement of Initiative itself attests to the prevalence of industry concerns regarding the effects of these practices on the integrity of the municipal securities market and underwriters.

The perception of conflicts of interest is also damaging to investor confidence. Although some commentators suggest that investor confidence has not been affected by "pay to play" practices,[58] the Commission, relying on its own expertise as well as the judgment of the MSRB, believes that the widespread reports of abuse adversely affect investor confidence, and that the MSRB's proposal will help to strengthen the integrity of the underwriting process

[51] Sections 15B(b)(2) (C), (G); [15 U.S.C. §§ 78o-4(b)(2) (C), (G)].

[52] The legislative history to the 1975 Acts Amendments adopting Section 15B indicated that Congress did not believe it would be desirable to restrict the MSRB's authority by a specific enumeration of subject matters. "The ingenuity of the financial community and the impossibility of anticipating all future circumstances are obvious reasons for allowing the [MSRB] a measure of flexibility in laying down the rules of the municipal securities industry." S. Rep. No. 75, *Securities Exchange Act of 1975: Report of the Committee on Banking, Housing, and Urban Affairs, to Accompany S. 249*, 94 Cong., 2d Sess 43 ("Senate Report") at 225.

[53] "S. 249 would provide, through amendment of the Exchange Act, a comprehensive pattern for the regulation of brokers, dealers, and banks trading municipal securities. The Committee feels that the lack of federal regulation . . . represents a serious threat to the integrity of the capital-raising system upon which local governments rely to finance their efforts." *Senate Report* at 215, 16.

[54] In the proposing and adopting releases for Rule 15c2-12, the Commission set forth its interpretation of the obligation of municipal securities underwriters under the antifraud provisions of the federal securities laws. The interpretation discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of statements made in connection with the offering. Securities Exchange Act Release No. 26100 (September 28, 1988), 53 FR 37778; Securities Exchange Act Release No. 26985 (July 10, 1989), 54 FR 28799.

[55] For example, one commentator states that "there have been relatively few reported instances of improper behavior in the market where approximately 15,000 issues are sold each year involving thousands of public officials * * *. Many of the high-profile cases of improper behavior that have been cited as evidence of corrupt practices caused by campaign giving are either illegal already or would not be affected by a prohibition on political contributions." Letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994). See also letter from Donald J. Borut, Executive Director, National League of Cities, to Jonathan Katz, Secretary, Commission (February 7, 1994); letter from Harlan E. Boyles, State Treasurer, North Carolina, to Arthur Levitt, Chairman, Commission (January 28, 1994).

Several commentators state that the majority of political contributions by municipal securities dealers and their associated persons are given for legitimate purposes and are unrelated to the selection of municipal securities underwriters. *E.g.*, letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994).

[56] *E.g.*, letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission, (March 10, 1994). The Government Finance Officers Association "believes that any improper relationship is properly a voter, taxpayer and ratepayer concern because of the potential impact such a relationship could have on the cost of the financing."

[57] See *supra* note 54.

[58] One commentator states that "[t]o my knowledge the practice of campaign contributions made by participants of the municipal securities industry has not resulted in bond defaults or other value losses that directly affect individual investors. Even the most egregious abuses documented in the national press have not resulted in investor losses in either primary offerings or in the secondary markets." Letter from Kenneth L. Rust, Debt Manager, Mayor, City of Portland, Oregon, to Jonathan Katz, Secretary, Commission (February 28, 1994).

and will help to restore and maintain investor confidence.[59]

2. Perfect the Mechanism of a Free and Open Market

As discussed above, several reports have indicated that "pay to play" practices are considered by many municipal securities underwriters to be an ordinary cost of doing business. Because of great competitive pressures to obtain business, municipal securities firms and the offering process are susceptible to abusive political contribution practices. "Pay to play" practices raise artificial barriers to competition for those firms that either cannot afford or decide not to make political contributions. Moreover, if "pay to play" is the determining factor in the selection of an underwriting syndicate, an official may not necessarily hire the most qualified underwriter for the issue. The proposal makes clear to municipal securities dealers and to officials of issuers that "pay to play" practices should no longer be employed to obtain municipal securities business. The proposal will further merit-based competition between municipal securities dealers and, thus, will remove impediments to and perfect the mechanism of a free and open market for municipal securities.

3. Promote Just and Equitable Principles of Trade

The proposal will promote just and equitable principles of trade. One of the primary principles of section 15B is to raise the level of conduct in the municipal securities industry.[60] "Pay to play" practices undermine these principles since underwriters working on a particular issuance may be assigned similar roles, and take on equivalent risks, but be given different allocations of bonds to sell—resulting in differing profits—based on their political contributions or contacts. The MSRB, under the Commission's supervision, was given primary rulemaking authority to regulate the conduct of municipal securities dealers by adopting rules to promote just an equitable principles of trade. In particular, the MSRB is obligated to assure that municipal securities dealers observe high professional standards in their activities with the public. The Statement of Initiative demonstrates the significance with which municipal securities dealers address reports of abuse in the municipal securities market. The proposal will extend the goals of the Statement of Initiative to all municipal securities dealers attempting to obtain municipal securities business.

4. Foster Cooperation and Coordination in Regulating Municipal Securities Transactions

The proposal will foster cooperation and coordination with persons engaged in regulating transactions in municipal securities. The proposal's disclosure and recordkeeping requirements will aid the Commission, the MSRB, and the NASD to oversee enforcement of and dealer compliance with the proposal.

5. Records and Record Retention

The proposal's record and record retention requirements are consistent with section 15B(b)(2)(G) of the Act which authorizes the MSRB to adopt rules that prescribe the records to be made and kept by municipal securities dealers and the periods for which such records shall be preserved. As discussed above, the proposal's record and record retention requirements, along with its prohibitions on municipal securities business, are designed to prevent "pay to play" practices in the awarding of municipal securities business.

B. First Amendment Guarantee of Free Speech

Several commentators believe that the proposal's prohibitions on political contributions impermissibly infringe on the First Amendment guarantees of freedom of speech and association,[61] and constitutional guarantees of equal protection.[62] These commentators believe that although municipal bond business should not be a "pay back" for political contributions, the proposal restricts the ability of municipal securities underwriters and their employees to demonstrate support for state and local officials.[63]

In light of the Commission's approval and enforcement of MSRB's rules, the Commission is sensitive to and has carefully considered these constitutional concerns in reviewing the proposed rule change.[64] The Commission acknowledges that the business disqualification provision may affect the propensity of municipal securities underwriters to make political contributions. Although political contributions involve both speech and associational rights protected by the First Amendment, a "limitation on the amount that any one person or group may contribute to a candidate or political committee entails only a marginal restriction upon the contributor's ability to engage in free communication."[65] Even a significant interference with rights protected by the

[59] Because, as discussed herein, regulation of political contributions by municipal securities dealers and municipal securities professionals is intended to enhance the fairness and efficiency of the municipal securities market, it is directly related to the purposes of the Act. Some commentators raise objections to the proposal on federalism grounds. *E.g.*, letter from David Norcross, General Counsel, Republican National Committee to Jonathan Katz, Secretary, Commission (March 11, 1994). Although the MSRB's proposal will have some effect on political fundraising activities of candidates for certain state and local offices, these effects do not transgress any limits on federal authority over state political activities. The MSRB's rules are directed at municipal securities dealers and municipal finance professionals and do not regulate the conduct of state officials. *Cf. New York* v. *United States*, 112 S. Ct. 2408 (1992). As such, the proposed rule change falls within the legitimate scope of the MSRB's congressionally-mandated jurisdiction regarding the conduct of municipal securities participants, notwithstanding any incidental effects on state elections.

[60] See *Senate Report* at 224, 25. Because the MSRB is an SRO for municipal securities dealers, it is an appropriate body to establish just and equitable principles of trade.

[61] One commentator, for example, states that "it is an infringement on individual first amendment rights to prohibit any person's financial support of a candidate because it is 'presumed' the contributor is involved in some 'pay to play' scheme." Letter from Michael E. Arrington, Chairman, Bi-County Sub-Committee, Maryland House of Delegates, to Arthur Levitt, Chairman, Commission (December 22, 1993). See *e.g.* letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994); letter from Marshall Bennett, President, and Bob Holden, Ethics Task Force, National Association of State Treasurers, to Jonathan Katz, Secretary, Commission (March 11, 1994); letter from David Norcross, General Counsel, Republican National Committee to Jonathan Katz, Secretary, Commission (March 11, 1994).

[62] One commentator, for example, states that "Rule G-37 fails to treat similarly-situated individuals in a like manner by classifying municipal broker-dealers and municipal finance professionals as the only persons subject to the burdens of the rule while other similarly situated persons, such as consultants and non-registered municipal finance professionals, are not subject to the same burden." Letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994).

[63] See *e.g.* letter from Donald J. Borut, Executive Director, National League of Cities, to Jonathan Katz, Secretary, Commission (February 7, 1994); letter from Michael E. Arrington, Chairman, Bi-County Sub-Committee, Maryland House of Delegates, to Arthur Levitt, Chairman, Commission (December 22, 1993); letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994).

[64] Several commentators disagree with the MSRB's conclusion that it is not a state actor for purposes of constitutional protections. See letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994); letter from Marshall Bennett, President, and Bob Holden, Ethics Task Force, National Association of State Treasurers, to Jonathan Katz, Secretary, Commission (March 11, 1994); letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994).

[65] *Buckley* v. *Valeo*. 424 U.S. 1, 20 (1976).

First Amendment may be justified by a sufficiently compelling government interest so long as the interference is closely drawn to avoid unnecessary abridgment of those protected rights.[66]

Prevention of fraud and manipulation and the appearance of fraud and manipulation are compelling government interests. The MSRB's proposal is in the context of a closely regulated industry and is directly relevant to the concerns of the regulatory scheme. The MSRB's interests in seeking approval of the proposed rule change—the eradication of "pay to play" practices and other *quid pro quo* arrangements—are precisely the kind of interests which have been deemed sufficiently compelling to justify restrictions on political contributions.[67] As discussed above, "pay to play" arrangements can have detrimental effects on the municipal securities markets; the widespread perception that these practices are commonplace undermines the integrity of the market and diminishes investor confidence. Moreover, the restrictions inherent in the MSRB's proposed rule change are in the nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries. Unlike general campaign financing restrictions, such as certain provisions of the Federal Election Campaign Act, which seek to combat unspecified forms of undue influence and political corruption, conflict of interest provisions, such as the MSRB's proposal, are tied to a contributor's business relationship with governmental entities and are intended to prevent fraud and manipulation.[68]

As previously noted, the Commission believes that the MSRB's proposed rule change is closely tailored to accomplish its goal of preventing fraudulent and manipulative acts and practices that stem from *quid pro quo* arrangements and minimizes any undue burdens on the protected speech and associational rights of municipal securities dealers and municipal finance professionals. The proposed rule change is narrowly crafted in terms of the conduct it prohibits, the persons who are subject to the restriction, and the circumstances in which it is triggered.

The proposal is limited to contributions to officials of municipal issuers who can influence the hiring of a dealer in connection with negotiated offerings. The restrictions are triggered only in situations where a business relationship exists or will be established in the near future between the municipal securities dealer and a municipal issuer. Most employees and affiliates of dealers are not covered by the proposal, and the dealer's municipal finance professionals will be able to avail themselves of a personal contribution exception of up to $250, individually, with respect to officials for whom they are eligible to vote. The proposal does not restrict uncoordinated independent expenditures in support of candidates or political views. Moreover, because the contribution limitations take the form of a business disqualification, the proposal does not flatly prohibit individuals from making, or prevent candidates from receiving contributions. In addition, the proposal does not, as some commentators suggest, restrict the ability of municipal securities underwriters and their employees to demonstrate support for state and local officials. Underwriters and their employees may continue to contribute in other ways in political campaigns that do not involve soliciting or coordinating contributions.[69]

The Commission believes that the proposed rule change is a necessary and appropriate measure to prevent fraudulent and manipulative acts and practices and the appearance of fraud and manipulation in the municipal securities market by eliminating "Pay to play" arranged underwritings. The proposal represents a balanced response to allegations of corruption in the municipal securities market; it provides specific prohibitions to help ensure that underwriter selection is based on expertise, not on the amount of money given to a particular candidate for office.

C. Municipal Securities Dealers: Small Firms and Minority and Women Owned Firms

Several commentators believe that the proposal will disadvantage small, regional municipal securities firms and firms owned by minorities or women.[70] Because larger firms may have more employees that may be eligible to use the *de minimis* exemption, these commentators believe that the proposal will provide larger firms an unfair advantage.[71]

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[66] *Id.* at 25.

[67] For example, Florida's Division of Bond Finance prohibits the awarding of municipal securities business to firms that make political contributions to the governor or to cabinet members. Florida State Board of Administration, Rule 19A–6.004. Florida also prohibits investment and law firms and their officers, directors, and employees that make contributions or engage in fundraising for state-level candidates from competing for business from the Florida Housing Finance Agency. Rules of the Florida Housing Finance Authority (1991). Several states prohibit contributions from corporations and regulated industries in state elections including Arizona, Ariz. Rev. Stat. Ann. § 16–919; Connecticut, Conn. Gen. Stat. Ann. § 9–333o(a); North Dakota, N.D. Cent. Code §§ 16.1–08–02(1), 16.1–08–01(10); Pennsylvania, Penn. Stat. Ann. tit. 25, § 3253; South Dakota, S.D. Codified Laws Ann. § 12–25–2; West Virginia, W. Va. Code § 3–8–8; Wisconsin, Wis. Stat. Ann. § 11.38; and Wyoming, Wyo. Stat. § 22–25–102.

[68] Compare 2 U.S.C. 441(a), (b) (general contribution restrictions in federal campaigns applicable to individuals, corporations and labor unions) with 2 U.S.C. § 441(c) (prohibition on contributions by federal contractors). Similarly, the prohibitions on solicitation and coordination of campaign contributions are justified by the same overriding purposes which support the business disqualification provisions. The provisions are intended to prevent circumvention of the disqualification provisions in cases where a dealer has or is seeking to establish a business relationship with a municipal issuer. Absent these restrictions, solicitation and coordination of contributions could be used as effectively as political contributions to distort the underwriter selection process. The solicitation and coordination restriction relate only to fundraising activities and would not prevent dealers and municipal finance professionals from expressing support for candidates in other ways.

[69] A number of states separately limit individual contributions in state elections including, for example: Arizona $640 per state wide candidate, $250 per other offices, and a maximum of $2,000 in total contribution per calendar year, Ariz. Rev. Stat. Ann. § 16–905; Florida, $500 per candidate, Flor. Stat. Ann. § 106.08; and Montana, $1,500 collectively to candidates for governor and lieutenant governor, $750 to candidates for state office in a statewide election, $400 to candidates for public service commissioner, district court judge, or state senator, $250 to a candidate for any other public office, Mont. Code Ann. §§ 13–1–101, 13–37–216.

[70] See *e.g.*, letter from Timothy L. Firestine, Director of Finance, Montgomery County Government, to Jonathan Katz, Secretary, Commission (February 24, 1994); letter from Stan W. Helgerson, Finance Director, Village of Carol Stream, Illinois, to Jonathan Katz, Secretary, Commission (March 10, 1994); letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994); letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary, Commission (March 9, 1994).

[71] One commentator, for example, states that "larger firms with multiple departments including those not devoted to public finance will be able to support candidates through contributions made by corporate or other specialists who are not affected by this rule. Minority- and women-owned firms typically are small speciality public finance firms so their employees would be barred from supporting candidates." Letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994).

Another commentator recommends that the proposal should extend the *de minimis* exemption to officials for whom the municipal securities finance professionals are not entitled to vote to allow "continuing access to clients and [enable] us to exercise our constitutional and political rights." Letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary, Commission (March 9, 1994). Another commentator recommends that the proposal exclude small issues (*e.g.* $10,000,000 par value or less) to lessen the impact of the rule on small regional, minority-owned, and women-owned firms. Letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H.

The Commission believes that the proposal will not have a disproportionate effect on minority or women-owned firms or on small and regional firms. The proposal clearly does not prevent local and state officials from selecting minority or women-owned municipal securities dealers for participation in municipal securities issuances.[72] Moreover, the proposal will apply equally to all municipal securities dealers seeking to obtain municipal securities underwriting business. The Commission is not aware of any evidence indicating that the proposed rule change will disproportionately affect minority or women-owned firms, or smaller and regional firms vis-a-vis large dealers. The Commission rejects the notion that campaign contributions are a unique and essential business development mechanism for small, regional, or minority and women-owned firms. As a practical matter, the proposal leaves open all legitimate marketing practices which firms, both large and small, may use to gain underwriting business such as sales presentations, seminars, and marketing documents. Moreover, the Commission believes that the costs of incidental, unintended effects, if any, are far outweighed by the benefits of restricting "pay to play" practices.

D. Effect on Women and Minority Candidates

Some commentators suggest that the proposal will adversely affect women and minority candidates for state and local office, or will inhibit the ability of municipal securities professionals to volunteer for public service.[73] The basis for this contention is uncertain, but the proposal is clearly not intended to affect any particular candidate or identifiable group of candidates in an adverse manner. As noted before, the restrictions relate only to those situations where contributions are directed to an official of a municipal issuer with which a dealer might do business. It does not prevent other forms of indirect financial support for a candidate, such as contributions to political action committees that are not controlled by the dealer or its municipal finance professionals, or independent expenditures.[74]

E. Candidates for Federal Office

Several commentators also suggest that the proposal should apply to contributions made to officials of or candidates for federal office.[75] Several commentators raise concerns that the proposal will restrict contributions to state and local officials running for federal office, without a similar limitation on contributions to the incumbent federal office holder.[76]

The Commission believes that it is not necessary to extend the proposal to include contributions to candidates for federal office. The proposal addresses abusive political contributions to officials of issuers who may influence the selection of municipal securities underwriters. Because federal office holders do not influence the underwriter selection process, the Commission believes that it would not be appropriate to include federal candidates under the rule's requirements.

By the same token, the Commission also believes that any resulting hardship to candidates for federal office who are currently local officials is not a reason for eliminating these requirements. The MSRB cannot overlook potential conflicts of interest solely because there are candidates for the same federal office who do not face the same conflicts. In any event, the resulting burden to current local officials does not appear to be significant. Generally, municipal underwriters play a less significant role as contributors in federal elections. Moreover, under federal law there exist general contribution restrictions that limit the amount of contributions that other candidates are able to obtain from municipal securities dealers and municipal finance professionals.[77]

F. Municipal Securities Dealer Affiliates

Several commentators believe that the proposal should apply to contributions from all employees affiliated with the underwriter and from affiliated financial institutions and their employees.[78] Several commentators specifically express concern that the proposal excludes contributions by chief executive officers of banks,[79] or by PACs controlled by banks or bank holding companies, which have a municipal securities dealer department

McFarland, Deputy Secretary, Commission (March 9, 1994).

[72] The Commission believes that promoting minority and women-owned firms is a valid goal. Other means exist to promote this goal. For example, the Commission understands that some issuers require the underwriting syndicate to include one or more minority or women-owned firms.

[73] "Many such candidates either lack substantial personal resources and/or live in districts with limited resources. It is essential, therefor, that such candidates be able to solicit broad support from outside sources." Letter from Marshall Bennett, President, and Bob Holden, Ethics Task Force, National Association of State Treasurers, to Jonathan Katz, Secretary, Commission (March 11, 1994).

[74] The proposal will not prevent contributions to "special-interest" PACs that are not controlled by the dealer or municipal finance professional unless the special interest PAC solicits contributions for the purpose of supporting an identifiable candidate. Thus, the proposal will have no effect on the ability of market participants to support candidates who represent their ideological, political, or social interests, or on the ability to volunteer for public service, notwithstanding concerns expressed by some commentators to the contrary. Letter from Robin L. Wiessmann, Principal, Artemis Capital Group, Inc., to Arthur Levitt, Chairman, Commission (December 21, 1993).

[75] *E.g.* letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary, Commission (March 10, 1994). One commentator objected to the proposal on the grounds that, with respect to municipal officials who are candidates for federal office, the MSRB's authority to adopt rules, subject to Commission approval, regulating campaign contributions of dealers and their employees conflicts with the jurisdiction of the Federal Election Commission ("FEC") under the regulatory scheme established in the Federal Election Campaign Act ("FECA"). Letter from David Norcross, General Counsel, Republican National Committee, to Jonathan Katz, Secretary, Commission (March 11, 1994). Although FECA confers exclusive jurisdiction for enforcing the provisions of FECA, the MSRB rules would not affect, directly or indirectly, the provisions of FECA or their enforcement. Rather, as discussed above, the MSRB's proposal is specifically tailored to eliminate conflicts of interest arising from political contributions and similar activities in selecting underwriters in connection with negotiated offerings of municipal securities.

[76] One comment letter, representing state and local officials, states: "While our organizations recognize the importance of maintaining the integrity of the municipal bond market, we are greatly concerned that the proposed rule is inherently unfair in its limited application to only state and local officials. We fail to understand why this proposed action by the Securities and Exchange Commission is not coupled with a comprehensive limitation on contributions to the federal branch of government, which has perhaps the greatest influence over the strength of the municipal bond market and investor confidence in that market."

Letter from Jerry Abramson, President, The United States Conference of Mayors, Sharpe James, President, The National League of Cities, Barbara Sheen Todd, President, The National Association of Counties, and Bonnie R. Kraft, President-Elect, the Government Finance Officers Association, to Arthur Levitt, Chairman Commission (February 18, 1994).

[77] See *supra* note 68.

[78] One commentator, for example, believes that the "rule is ineffective because it does not cover all related personnel who can continue to contribute to officials of issuers thereby creating the actual or apparent conflict of interest which the MSRB rule seeks to prevent." Letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994).

[79] Once commentator, for example, states that "[w]e strenuously object to a narrowly-based requirement that diminishes the ability of our Chief Executive and members of our executive committees to participate as community leaders, to engage in political dialogue and to develop our firm's profile in the communities in which we do business to the same extent as local bank chief executives." Letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

or subsidiary.[80] These commentators believe that by exempting affiliated banks and bank holding companies, the proposal provides a "loophole" for continued abuse of political contributions by municipal securities dealers and their affiliates.[81]

The Commission believes that the MSRB's proposed rule change is not deficient merely because it does not include affiliated banks and bank holding companies. Because of the sensitivity to constitutional and other concerns, the Commission believes that the coverage of the proposal is no broader than is necessary to effectuate its purpose and that extending the scope to cover affiliated banks and bank holding companies is not necessary.[82]

[80] One commentator, for example, states that "[c]ommercial banks would be free to continue making PAC contributions to local and state level political candidates and in the process gain a significant competitive advantage in the selection process for public finance undertakings. Those candidates receiving bank PAC contributions would certainly remember such support when bank dealer personnel are introduced or accompanied by commercial bankers in the selection process. It is a typical procedure for the local bank officer to lobby and/or speak in behalf of the hiring of his public finance entity." Letter from Clifford A. Lanier, Jr., The Frazer Lanier Company, to David C. Clapp, Chairman, MSRB (March 1, 1994).

Another commentator states that "[i]t is unreasonable to believe that political candidates, including 'issuer officials,' will be able or need to, discern between contributions from a bank-controlled PAC and a bank's municipal securities 'dealer-controlled' PAC. This appears to us to represent 'business as usual' for bank-controlled municipal dealers while we are both stigmatized and potentially disadvantaged competitively." Letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

[81] "Unfortunately, the proposed rule as written is so severely deficient in ignoring the sophisticated realities of political fundraising undertaken by securities firms, that the loopholes and fine distinctions posed promise to provide a road map for more sinister activities, possibly making the situation worse." Letter from Mark D. Schwartz, to Arthur Levitt, Chairman, Commission (January 31, 1994).

Several commentators question the ability of the MSRB or the NASD to enforce Rule G-37. For example, one commentator believes that "[p]olitical favors will to those investment banks that flaunt or circumvent the rule while those firms who live by the rules will suffer accordingly." Letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary, Commission (March 9, 1994).

[82] The Commission will monitor closely the implementation of the proposal and its effects on the market, and if it determines that abusive practices continue to exist, will encourage the MSRB to expand the scope of the rule. In response to the suggestion that financial advisers be required to register as municipal securities broker-dealers and be subject to the proposal, the Commission notes that such a recommendation is beyond the scope of this proposal. See *e.g.*, letter from Vivian Altman, Altman & Co., to Jonathan Katz, Secretary, Commission (January 31, 1994).

G. De Minimis Exemption

Several commentators recommend that the proposal increase the *de minimis* amount that municipal finance professionals may contribute.[83] Several commentators recommend that the rule should provide a "good faith" exemption for inadvertent violations.[84] One commentator recommends that the rule provide a "safe harbor" provision for certain contributions.[85] Another commentator believes that the proposal should exempt contributions made for legitimate purposes.[86]

[83] These commentators express concern that inadvertent violations by municipal securities dealers or associated persons covered by the rule may prevent dealers from participating in an underwriting, and, thus, raise the cost of a municipal securities issuance. For example, one commentator states that "we are concerned that your rule could deprive a state or local government of the opportunity to work with a company which may be offering the most desirable rates simply due to a technical infraction." Letter from Jerry Abramson, President, The United States Conference of Mayors, Sharpe James, President, The National League of Cities, Barbara Sheen Todd, President, The National Association of Counties, and Bonnie R. Kraft, President-Elect, the Government Finance Officers Association, to Arthur Levitt, Chairman, Commission (February 18, 1994).

[84] For example, one commentator states that "[c]learly, the tradition of broker-dealer regulation in the U.S. is based upon the requirement that securities firms have adequate policies and procedures in place to assure compliance with laws and regulations not that each broker-dealer be guarantor of perfect compliance." Letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994). Another commentator believes that the proposal, "consistent with many other rules and regulations applicable to the securities industry, may achieve its purposes but temper its remedy for firms with adequate compliance procedures and supervision." Letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994). *See also* letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts & Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994); letter from George B. Pugh, Jr., Chairman, Municipal Securities Division, Public Securities Association to Jonathan Katz, Secretary, Commission (March 11, 1994).

Several commentators raise concerns that aggrieved employees may make contributions to deliberately prevent a firm from obtaining municipal securities business. *E.g.*, letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994); letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

[85] For example charitable contributions, contributions to non-partisan associations in which elected officials may be members or participants, support of ballot propositions, certain services in the normal course of business, contributions by spouses or household members, contributions to national political parties, contributions to state and local political parties and certain contributions to political action committees. Letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary Commission (March 10, 1994).

[86] Letter from Raymond J. McClendon, Vice-Chairman and Chief Operating Officer, Pryor, McClendon, Counts and Co., Inc., to Margaret H. McFarland, Deputy Secretary, Commission (March 9, 1994).

Several commentators believe that the *de minimis* exemption should be expanded to include contributions to officials for whom the municipal finance professionals are not entitled to vote.[87] These commentators believe that the proposal prevents municipal securities dealers from establishing business relationships with issuers,[88] and from supporting candidates with similar views important to the municipal finance professional or to the municipal securities broker-dealer firm.[89] One commentator recommends that the proposal allow contributions to candidates that represent the area in which the professionals' principal office is located.[90]

The Commission believes that the MSRB's determinations as to the amount of the de minimis exemption and limiting its application to contributions to officials for whom the municipal finance professional is entitled to vote are appropriate and reasonable. As discussed, the proposal provides specific guidelines to prevent "pay to play" contributions. The proposal provides an appropriate balance between limiting "pay to play" practices and the ability of dealers and their employees to demonstrate support for state and local candidates. The proposal recognizes that certain contributions made for legitimate political purposes present less risk of a conflict of interest or the appearance of a conflict of interest. Although an individual may have a legitimate

[87] For example, one commentator believes that "[d]ealers should not be prohibited from making contributions to persons for whom they are unable to vote. They should have a right to support the candidates of their choice." Letter from Jeffrey L. Esser, Executive Director, Government Finance Officers Association, to Jonathan Katz, Secretary Commission (March 10, 1994).

[88] Letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary Commission (March 9, 1994).

[89] For example, one commentator believes that "[t]he provision limiting contributions to one's voting jurisdiction denies municipal securities professionals access to politicians who influence their corporate and individual political interests. Specifically, municipal securities professionals will be denied the ability to support politicians who champion their personal beliefs or corporate concerns. For example, a firm headquartered in New York City whose president and employees live on Long Island would be unable to send a representative to a dinner for the mayor of New York City or for the mayor's political opponent. Yet the mayor's decisions on issues such as zoning, corporate taxes, and transportation policy significantly impact the company's viability." Letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary, Commission (March 9, 1994)

[90] Letter from Gerald E. Pelzer, President, Clayton Brown & Associates, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

interest in making contributions to candidates for whom she is ineligible to vote, there is a greater risk in such circumstances that the contribution is motivated by an improper attempt to influence municipal officials. Thus, the proposal enables municipal finance professionals to contribute $250 per election to candidates for whom they are entitled to vote without triggering the proposal's business limitation. As discussed, the proposal does not prevent dealers or their employees from demonstrating support for local and state officials in other ways including volunteer political campaign activity.

H. General Provisions

Several commentators believe that the proposal is operationally too burdensome to implement. These commentators believe that because of the number and types of persons subject to the rule's prohibitions, it will be difficult for municipal securities dealers to implement and enforce compliance procedures.[91] Some commentators believe that the proposal's disclosure and recordkeeping requirements are overly burdensome.[92] Several commentators also believe that the scope of the proposal is uncertain and recommend that it provide more complete standards regarding employee contributions,[93] the use of consultants and law firms,[94] bonds issued by corporations with the assistance of local governments,[95] the definition of "election,"[96] and the definition of "official of such issuer."[97] One commentator requests that the proposal contain a "sunset" provision to require the MSRB to review rule G–37 after a fixed number of years.[98]

The Commission believes that the proposal's provisions are sufficiently specific to permit compliance with its terms. The Commission also understands that industry efforts are currently underway to draft proposed guidelines to assist dealer compliance with the proposal. In addition, the MSRB will provide continued interpretive guidance to assist dealer compliance with the proposal. The Commission, in accordance with its statutory mandate, will continue to monitor the implementation of the proposal and the effects the proposal may have on the market.

I. Amendment No. 1

The Commission finds good cause for approving the MSRB's Amendment No. 1, pursuant to Section 19(b)(2) of the Act, prior to the thirtieth day after the date of publication of notice of the amendment. As originally submitted, the proposal's prohibitions on municipal securities business would arise from contributions made on or after April 1, 1994. The MSRB filed the amendment to change the April 1, 1994 date to a date 10 days after publication in the **Federal Register** of the order approving the proposal. The MSRB also amended the proposal to change the effective date of the proposal's disclosure and recordkeeping requirements to a date 10 days after publication of the approval order in the **Federal Register**. Thus the proposal's prohibitions will arise from contributions made on or after April 25, 1994. The proposal's disclosure and recordkeeping requirements also will not be effective until April 25, 1994. The Commission believes that the amendments will facilitate compliance by municipal securities dealers. The amendments, in conjunction with the proposal's notice and comment period, will provide municipal securities dealers sufficient time to adopt and implement procedures to comply with the proposal.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the MSRB's Amendment No. 1. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the amendment that are filed with the Commission, and all written communications relating to the amendment between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section. Copies of the amendment also will be

[91] For example, Piper Jaffray Inc. expresses concern regarding the ability of broker-dealer firms to screen newly hired employees or current employees seeking employment with the firm's municipal securities departments, and the ability to hire civil servants. Piper Jaffray Inc. believes that "[t]his would require firms to screen all applicants for these jobs by requiring them to declare to whom they made political contributions and make judgmental evaluations as to whether their earlier campaign activities would be potentially violative of the rule and not offer a job to any offending contributor." Piper Jaffray Inc. believes that this will almost certainly expose broker-dealer firms to the risk of civil litigation. Letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994). Another commentator states that "a person who has made a contribution within the past two years apparently taints a firm which hires the individual even if the individual was not involved in the municipal securities business at the time of the contribution. Two serious problems exist. The first is that even a firm with strict reviews for hiring may find itself barred * * *. The second is that many active citizens will find themselves de facto barred from entering the public finance, banking and brokerage businesses." Letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

[92] *E.g.*, letter from A.B. Krongard, Chief Executive Officer, Alex, Brown & Sons, to Jonathan Katz, Secretary, Commission (March 15, 1994); letter from Robert F. Price, Chairman, Federal Regulation Committee, Securities Industry Association, to Jonathan Katz, Secretary, Commission (March 17, 1994). The Securities Industry Association believes that the proposal's reporting provisions should be amended to: (1) Require quarterly submissions for only those quarters in which the dealer has any contributions to report; (2) delete the requirement to report lists of issuers with which the dealer conducts municipal securities business; and (3) delete the requirement to disclose the name, company, role, and compensation arrangement of any person employed by the dealer to obtain municipal securities business.

[93] For example, A.G. Edwards & Sons, Inc. believes that the "provision is ambiguous. Read most broadly the definition of municipal finance professional in proposed Rule G–37 could be construed to include any retail broker who sells municipal securities * * *. As a result of the possible ambiguity and the changing application, firms employing retail brokers likely will interpret the provision broadly to avoid being barred from the municipal finance business. The result will be that numerous brokers who have no participation in securing municipal securities business will be barred from political activities." Letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

[94] *E.g.*, Letter from William H. Ellis, President and Chief Operating Officer, Piper Jaffray Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994). One commentator recommends the proposal clarify that the definition of municipal finance professional excludes independent law firms or persons retained by a dealer for purposes other than the solicitation of municipal securities business. Letter from Richard H. Martin, Attorney, Leonard, Street and Deinard, to Jonathan Katz, Secretary, Commission (March 8, 1994).

One commentator recommends that the proposal should be clarified to exclude from the definition of municipal finance professional any independent firms or persons retained by a broker-dealer for purposes other than the solicitation of municipal securities business. Letter from Richard H. Martin, Attorney, Leonard, Street and Deinard, to Jonathan Katz, Secretary, Commission (March 8, 1994).

[95] *Id.*

[96] One commentator, for example, states that "[a]n election should be defined and it should be made clear that if a contributor gives for a specified election, the amount shall only be considered as a contribution for the election for which the amount was given even if the candidate has the legal right to carry over amounts to other elections." Letter from D. Kelly, A.G. Edwards & Sons, Inc., to Jonathan Katz, Secretary, Commission (March 10, 1994).

[97] "An influence standard leaves the industry uncertain as to whom contributions may be made and, judged retrospectively, may cause inadvertent violations." *Id.*

[98] This "would allow all parties to regularly review G–37 to determine whether G–37 is effective and meeting the goals it was created to achieve and to accommodate any other relevant developments such as campaign finance reform." Letter from Carolie R. Smith, President, Smith Mitchell Investment Group, Inc., to Jonathan Katz, Secretary, Commission (March 9, 1994).

available for inspection and copying at the principal office of the MSRB. All submissions should refer to the file number in the caption above and should be submitted by May 4, 1994.

VII. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the MSRB and, in particular, section 15B(b)(2)(C).

It is therefore ordered, Pursuant to section 19(b)(2) of the Act, that the proposed rule change and Amendment No. 1 described above be, and hereby are, approved, and shall be effective April 25, 1994.[99]

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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NASD NOTICE TO MEMBERS 94-35

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- ☐ Training

Executive Summary

On March 29, 1994, the Securities and Exchange Commission (SEC) approved amendments to Article II, Sections 10 and 11 of the Code of Procedure that allow the National Business Conduct Committee (NBCC) to designate a Subcommittee composed of members of the NBCC to review Letters of Acceptance, Waiver, and Consent (AWCs); Minor Rule Violations Letters; and Offers of Settlement. The text of the amendment follows the discussion below.

Background And Description Of The Amendment

On March 29, 1994, the Securities and Exchange Commission approved amendments to Article II, Sections 10 and 11 of the Code of Procedure that allows the National Business Conduct Committee to designate a subcommittee composed of members of the NBCC to review AWCs, Minor Rule Violations Letters, and Offers of Settlement in most instances.

The NBCC is composed of participating members of the first-year class of the NASD Board of Governors (Board) plus an elected Chair and Vice Chair from the Board's second-year class. The members of the NBCC receive a weekly package (weekly mailing) for review on proposed AWCs, Minor Rule Violations Letters, and Offers of Settlement. In addition, the NBCC also reviews, on a weekly basis, all disciplinary decisions of the District Business Conduct Committee and the Market Surveillance Committee. All matters are first reviewed by the Chair and Vice Chair of the NBCC and then reviewed by the other members of the NBCC along with the recommendations of the Chair and Vice Chair.

The NASD has determined that the weekly mailings to the NBCC constitute a substantial portion of time commitment required of NBCC members and that the review by NBCC members of all the forgoing matters is unnecessary and unduly burdensome. Therefore, the NASD is amending the Code of Procedure to allow acceptances and rejections of AWCs, Minor Rule Violations Letters, and Offers of Settlement to be made by a subcommittee designated by the NBCC instead of full NBCC review in all instances other than matters that are outside the *NASD Sanction Guidelines* or where the designated subcommittee, in its discretion, otherwise believes full NBCC review is appropriate.[1] The NASD intends that, initially, the subcommittee designated by the NBCC will consist of the NBCC Chair and Vice Chair, but may modify the composition of the subcommittee in the future.

Additionally, the NASD has amended Section 11(e) of Article II by deleting the phrase "by majority vote" because it considers the phrase confusing and believes that a majority vote is always required by an NASD review body acting pursuant to the Code of Procedure.

Questions regarding the Notice may be directed to Norman Sue, Jr., Associate General Counsel, at (202) 728-8117.

Text of amendments to Article II, Sections 10 and 11 of the NASD Code of Procedure

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[1] The *NASD Sanction Guidelines* were published in May 1993 and sent to all NASD members. See, also *NASD Regulatory & Compliance Alert*, Volume 7, No. 2 (June 1993).

(**Note:** New language is underlined; deletions are in brackets.)

Article II

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Sec. 10

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Acceptance, Waiver and Consent of the Respondent

(a) If the Committee has reason to believe a violation has occurred and the member or associated person does not dispute the violation, the Committee may suggest that the member or associated person submit a letter containing an acceptance of a finding of violations, a waiver of all rights of appeal to the National Business Conduct Committee (and any review thereof by the Board of Governors), the Securities and Exchange Commission and the courts or to otherwise challenge or contest the validity of the Order issued if the letter is accepted, and a consent to the imposition of sanctions. The letter shall describe the act or practice engaged in or omitted; the rule, regulation or statutory provision violated; and the sanction to be imposed therefore. If the Committee then concludes that the Letter of Acceptance, Waiver and Consent is appropriate and should be accepted, it shall be submitted to the National Business Conduct Committee. If the letter is accepted by the National Business Conduct Committee or a Subcommittee designated by the National Business Conduct Committee, it shall become final and shall constitute the complaint, answer and decision in the matter. If the letter is rejected by the Committee, [or] the National Business Conduct Committee, or a Subcommittee designated by the National Business Conduct Committee, any acceptances, waivers and consents contained therein shall not be considered in any further complaint action which may be taken against the member or associated person.

Minor Rule Violations Procedure

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b(3) The Letter shall be submitted to the Committee and, if accepted, the Letter shall then be submitted to the National Business Conduct Committee. If the National Business Conduct Committee or a Subcommittee designated by the National Business Conduct Committee accepts the Letter, the Corporation will report the violation to the Securities and Exchange Commission as required by the Commission pursuant to a plan approved under Rule 19d-1(c)(2) adopted under the Securities Exchange Act of 1934, as amended. If the Committee, [or] the National Business Conduct Committee, or a Subcommittee designated by the National Business Conduct Committee rejects the Letter, the Committee or National Business Conduct Committee may take any other appropriate disciplinary action with respect to the violation or violations.

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Settlement Procedure

Sec. 11

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(e) Before any such Order of Acceptance of Offer of Settlement shall become effective it must be submitted to and approved by the National Business Conduct Committee or a Subcommittee designated by the National Business Conduct Committee, which is hereby delegated authority to accept or reject an Offer of Settlement. If the National Business Conduct Committee [by a majority vote] or a Subcommittee designated by the National Business Conduct Committee approves the Committee's Order, it shall communicate its conclusion to the Committee which shall thereafter issue such Order.

NASD NOTICE TO MEMBERS 94-36

SEC Approves Communication Guidelines For Variable Products

Suggested Routing

- ■ Senior Management
- ■ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ■ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training

Executive Summary

On March 21, 1994, the Securities and Exchange Commission (SEC) approved amendments that provide guidelines for communications with the public about variable life insurance and variable annuities (Guidelines). The Guidelines govern the preparation of, and communication with the public through, advertising and sales literature of variable products. The Guidelines are intended to provide a level of disclosure sufficient to assist in making fair and informed investment decisions. The text of the amendment, which is effective March 21, 1994, follows the discussion below.

Background And Description Of The Amendment

As the number of variable life insurance and annuity products has increased substantially in recent years, so has the variety of ways in which information about such products is communicated to the public. Because the use of such communications is proliferating, and because what is being described in such communications is, in some cases, a complicated hybrid product containing both insurance and securities elements, the NASD has determined to provide guidance by adopting a comprehensive set of Guidelines for the preparation and use of communications with the public regarding variable life insurance and variable annuities. The Guidelines, approved by the SEC on March 21, 1994, incorporate past positions on variable products communications taken by the NASD, as well as certain positions taken by the staff of the Securities and Exchange Commission.

The Guidelines govern the preparation of, and communication with the public through, advertising and sales literature of variable products. The Guidelines are intended to provide a level of disclosure sufficient to assist investors in making fair and informed investment decisions.

The Guidelines set forth standards that must be considered, along with the standards set forth in Article III, Section 35 to the Rules of Fair Practice, in the preparation of advertising and sales literature about variable life insurance and annuities. For the purposes of these Guidelines, the terms "advertisements and sales literature" includes not only the definitions of those terms as found in Section 35, but also individualized communications such as personalized letters and printed or on-screen computer illustrations.

General Considerations

In light of the complexities and unique nature of variable products, it is essential that potential investors understand what they are being offered. Consequently, the Guidelines require that communications concerning variable products must clearly identify the product. Where product type is identified in a proprietary name, it is not necessary to include a generalized statement identifying product type. In order to prevent confusion in variable product sales material, no statement or presentation may indicate or imply that the product offered or its underlying account is a mutual fund. Although variable product separate accounts may ultimately be invested in mutual funds, there are significant material differences between a variable product investment and a direct mutual fund investment.

As products with potentially sub-

stantial tax penalties and charges for early withdrawal, variable products must not be presented by members as short-term, liquid investments. Any discussions or presentations concerning liquidity or accessibility to investment values must be balanced by disclosure of the impact of early withdrawal, such as sales loads, tax penalties, and potential loss of principal. Additionally, regarding the liquidity of variable life insurance products, a balanced presentation requires a discussion of the impact of loans and withdrawals on cash values and death benefits.

Guarantees by insurance companies, such as a minimum death benefit, a schedule of annuity payments, or a fixed return on the investment account, all depend on the claims-paying ability of the issuing insurance company, and thus must not be exaggerated. Members are prohibited from representing or implying that the investment return or principal value of the separate investment account is guaranteed, or that an insurance company's financial ratings apply to the separate account.

Specific Considerations

Prior Fund Performance
The guidelines allow variable product communications to contain the historic performance of an existing fund that pre-dates the fund's inclusion in the variable policy or annuity, provided no significant changes occurred to the fund at the time of, or after, the inclusion. A variable product that contains a new, or "clone," fund as the underlying investment vehicle is prohibited from using communications with the public that promote the performance history of the existing fund on which the new, or "clone," fund is modeled. All historic performance in communications to the public must conform to applicable NASD and SEC standards, including, in particular, all elements of return and deduction of applicable charges and expenses.

Product and Performance Comparisons
Product comparisons that are fair may help investors to make informed investment decisions. Article III, Section 35(d)(2)(M) of the NASD Rules of Fair Practice requires that a member who makes investment comparisons directly or indirectly, in a communication with the public, must ensure that the purpose of the comparison is clear and that the comparison is fair and balanced, including any material differences between the subjects of the comparisons. The Guidelines permit a comparison using variable products so long as the comparison meets the standards set forth under Subsection (d)(2)(M).

Variable Life Products
Variable life insurance allows purchasers to combine life insurance coverage and tax-deferred accumulation of excess premium payments in one contract. Because such products are designed to serve both insurance and investing needs equally , communications with the public on behalf of variable life insurance products must provide a balanced discussion of these features. However, since single premium variable life insurance is predominantly designed to meet investment needs, communications with the public regarding single premium variable life insurance may emphasize the investment features of the product so long as an adequate explanation of the life insurance features is given.

Hypothetical and Personalized Illustrations of Variable Life Products
Hypothetical illustrations of variable life insurance products using assumed rates of return are permissible to show how performance of the underlying investment accounts could affect the policy cash value and death benefit, but may not be used to predict or project investment results. Such illustrations must follow the methodology and form requirements for such illustrations in the prospectus.

All illustrations must show a hypothetical zero percent gross rate of return, and may show any additional combinations of rates of return up to and including a gross rate of 12 percent, though members are cautioned to choose a rate that is reasonable given current market conditions. All illustrations of rates of return must reflect maximum charges, though illustrations may reflect current charges in addition to maximum charges.

Sales literature that contains hypothetical illustrations may also provide a personalized illustration reflecting factors relating to the circumstances of an individual customer.

The Guidelines require clear disclosure to precede any illustration that explains the purpose and hypothetical nature of the illustration. It is generally inappropriate and potentially misleading to compare a variable life insurance policy with another product, including a variable annuity, since the purpose of such a comparison would exceed the purpose of illustrating how underlying investment account performance affects the policy cash value and death benefit. However, it is permissible to use a hypothetical illustration comparing a variable life policy to a term policy with the difference in premium invested in a side fund, where the sole purpose of such a comparison would be to

demonstrate the concept of tax-deferred growth as a result of investing in the variable product. In order for such a comparison to be balanced and complete, the comparative illustration must: use a rate of return no greater than 12 percent; use the same rate of return for the variable product and the side fund; deduct the same fees as those deducted from the required prospectus illustration; illustrate the side fund product using gross values that do not reflect the deduction of any fees; and, not characterize the side product as any specific investment or investment type.

Questions regarding the Notice may be directed to Robert J. Smith, Attorney, Office of General Counsel, (202) 728-8176, or R. Clark Hooper, Vice President, Advertising/Investment Companies Regulation, (202) 728-8325.

Guidelines For Communications With The Public About Variable Life Insurance And Variable Annuities

(**Note**: New language is underlined.)

The standards governing communications with the public are set forth in Article III, Section 35 of the NASD Rules of Fair Practice. In addition to those standards, these guidelines must be considered in preparing advertisements and sales literature about variable life insurance and variable annuities. The guidelines are applicable to advertisements and sales literature as defined in Section 35, as well as individualized communications such as personalized letters and computer generated illustrations, whether printed or made available on-screen.

I. GENERAL CONSIDERATIONS

A. Product Identification

In order to assure that investors understand exactly what security is being discussed, all communications must clearly describe the product as either a variable life insurance policy or a variable annuity, as applicable. Member firms may use proprietary names in addition to this description. In cases where the proprietary name includes a description of the type of security being offered, there is no requirement to include a generalized description. For example, if the material includes a name such as the "XYZ Variable Life Insurance Policy," it is not necessary to include a statement indicating that the security is a variable life insurance policy.

Considering the significant differences between mutual funds and variable products, the presentation must not represent or imply that the product being offered or its underlying account is a mutual fund.

B. Liquidity

Considering that variable life insurance and variable annuities frequently involve substantial charges and/or tax penalties for early withdrawals, there must be no representation or implication that these are short-term, liquid investments. Presentations regarding liquidity or ease of access to investment values must be balanced by clear language describing the negative impact of early redemptions. Examples of this negative impact may be the payment of contingent deferred sales loads and tax penalties, and the fact that the investor may receive less than the original invested amount.

With respect to variable life insurance, discussions of loans and withdrawals must explain their impact on cash values and death benefits.

C. Claims About Guarantees

Insurance companies issuing variable life insurance and variable annuities provide a number of specific guarantees. For example, an insurance company may guarantee a minimum death benefit for a variable life insurance policy or the company may guarantee a schedule of payments to a variable annuity owner. Variable life insurance policies and variable annuities may also offer a fixed investment account which is guaranteed by the insurance company. The relative safety resulting from such a guarantee must not be overemphasized or exaggerated as it depends on the claims-paying ability of the issuing insurance company. There must be no representation or implication that a guarantee applies to the investment return or principal value of the separate account. Similarly, it must not be represented or implied that an insurance company's financial ratings apply to the separate account.

II. SPECIFIC CONSIDERATIONS

A. Fund Performance Predating Inclusion in the Variable Product

In order to show how an existing fund would have performed had it been an investment option within a variable life insurance policy or variable annuity, communications may contain the fund's historical performance that predates its inclusion in the policy or annuity. Such performance may only be used provided that no significant changes occurred to the fund at the time or after it became part of the variable product. However, communications may not include the performance of an existing fund for the purposes of promoting investment in a similar, but new, investment option (i.e., clone fund or model fund) available in a variable contract.

The presentation of historical performance must conform to applicable NASD and SEC standards. Particular attention must be given to including all elements of return and deducting applicable charges and expenses.

B. Product Comparisons

A comparison of investment products may be used provided the comparison complies with applicable requirements set forth under Article III, Section 35 of the NASD Rules of Fair Practice. Particular attention must be paid to the specific standards regarding "comparisons" set forth in subsection (d)(2)(M).

C. Use of Rankings

A ranking which reflects the relative performance of the separate account or the underlying investment option may be included in advertisements and sales literature provided its use is consistent with the standards contained in the Guidelines for the Use of Rankings in Mutual Fund Advertisements and Sales Literature*

D. Discussions Regarding Insurance and Investment Features of Variable Life Insurance

Communications on behalf of single premium variable life insurance may emphasize the investment features of the product provided an adequate explanation of the life insurance features is given. Sales material for other types of variable life insurance must provide a balanced discussion of these features.

E. Hypothetical Illustrations of Rates of Return in Variable Life Insurance Sales Literature and Personalized Illustrations

(1) Hypothetical illustrations using assumed rates of return may be used to demonstrate the way a variable life insurance policy operates. The illustrations show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. These illustrations may not be used to project or predict investment results as such forecasts are strictly prohibited by the Rules of Fair Practice. The methodology and format of hypothetical illustrations must be modeled after the required illustrations in the prospectus.

An illustration may use any combination of assumed investment returns up to and including a gross rate of 12%, provided that one of the returns is a 0% gross rate. Although the maximum assumed rate of 12% may be acceptable, members are urged to assure that the maximum rate illustrated is reasonable considering market conditions and the available investment options. The purpose of the required 0% rate of return is to demonstrate how a lack of growth in the underlying investment accounts may affect policy values and to reinforce the hypothetical nature of the illustration.

The illustrations must reflect the maximum (guaranteed) mortality and expense charges associated with the policy for each assumed rate of return. Current charges may be illustrated in addition to the maximum charges.

Preceding any illustration there must be a prominent explanation that the purpose of the illustration is to show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. The explanation must also state that the illustration is hypothetical and may not be used to project or predict investment results.

(2) In sales literature which includes hypothetical illustrations, member firms may provide a personalized illustration which reflects factors relating to the individual customer's circumstances. A personalized illustration may not contain a rate of return greater than 12% and must follow all of the standards set forth in Section II.E.1.

(3) In general, it is inappropriate to compare a variable life insurance policy with another product based on hypothetical performance as this type of presentation goes beyond the singular purpose of illustrating how the performance of the underlying investment accounts could affect the policy cash value and death benefit. It is permissible, however, to use a hypothetical illustration in order to compare a variable life insurance policy to a term policy with the difference in cost invested in a side product. The sole purpose of this type of illustration would be to demonstrate the concept of tax-deferred growth as a result of investing in the variable product. The following conditions must be met in order to make this type of comparison balanced and complete:

(a) the comparative illustration must be accompanied by an illustration which reflects the standards outlined in Section II.E.1;

(b) the rate of return used in the comparative illustration must be no greater than 12%;

(c) the rate of return assumed for the side product and the variable life policy must be the same;

* Guidelines for the Use of Rankings in Mutual Fund Advertisements and Sales Literature, have been filed with, and are currently awaiting approval by, the Securities and Exchange Commission in rule filing SR-NASD-93-69.

(d) the same fees deducted from the required prospectus illustration must be deducted from the comparative illustration;

(e) the side product must be illustrated using gross values which do not reflect the deduction of any fees; and,

(f) the side product must not be identified or characterized as any specific investment or investment type.

NASD NOTICE TO MEMBERS 94-37

SEC Issues Interpretive Statement Regarding Municipal Securities Disclosures; Proposes Changes To Rule 15c2-12

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ■ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ■ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ■ Syndicate
- ☐ Systems
- ☐ Trading
- ■ Training

Executive Summary

Effective March 9, 1994, the Securities and Exchange Commission (SEC) published an interpretive statement regarding the disclosure obligations of participants in the municipal securities markets. The SEC is seeking comment on the issues discussed in its statement. In a companion release, the SEC published for comment proposed changes to Rule 15c2-12 under the Securities Exchange Act of 1934 (Act) that would prohibit broker/dealers from underwriting and recommending municipal securities for which adequate information is not available. Comments on these issues are due on or before July 15, 1994.

Background

In September 1993, the Staff of the SEC Division of Market Regulation reported to Congress on several aspects of the municipal securities market. One of the topics discussed was the disclosure requirements of various market participants.

According to the report, investors need sufficient current information about issuers to protect themselves from fraud and manipulation, to evaluate offering prices, to decide which municipal securities to buy, and to decide when to sell. In addition, the report found that, with the growing number of individual investors purchasing municipal securities, the need for sound recommendations by broker/dealers is assuming even greater importance.

As a result of these findings, the SEC decided to issue interpretive guidance regarding disclosure under the anti-fraud provisions of the federal securities laws. The SEC issued its statement March 9, 1994.

In a companion release, the SEC also proposed rule amendments to existing Rule 15c2-12. The amendments would prohibit a broker/dealer from underwriting an issue of municipal securities unless the issuer or its designated agent has undertaken in a written agreement or contract to provide certain information to a nationally recognized municipal securities information repository. Moreover, the proposed changes would prohibit a broker/dealer from recommending the purchase or sale of a municipal security without having reviewed the information the issuer has provided.

Description Of SEC Interpretive Statement

The SEC statement issued on March 9, 1994, focuses largely on the disclosure obligations of municipal securities issuers. It notes that, while disclosure by municipal issuers has significantly improved over the last two decades for primary offerings, concerns still exist, particularly for offerings of non-general obligation bonds and smaller issues. The statement goes on to note that secondary market disclosure practices present greater concerns.

In its statement, the SEC discusses the application of the anti-fraud provisions of the federal securities laws to disclosure in both the primary offering and secondary markets. The statement also addresses voluntary guidelines issued by the Government Finance Officers Association that have gained acceptance among a number of larger issuers. A significant portion of the statement focuses on areas where improvement is needed.

For the obligations of municipal securities broker/dealers, the statement reaffirms interpretations expressed by the SEC during the proposal and adoption of Rule 15c2-

12 in 1989. According to the SEC, underwriters must have a reasonable basis for recommending any securities and, in fulfilling that obligation, they must review in a professional manner the accuracy of statements made in connection with the offering.

The SEC also emphasizes the responsibilities of broker/dealers trading securities in the secondary market. Unlike an underwriter, a broker/dealer ordinarily is not obligated to contact the issuer to verify information. However, if a broker/dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for further inquiry, a broker/dealer may need to obtain additional information, or seek to verify existing information.

Rule 15c2-12 Proposals

The SEC adopted Rule 15c2-12 to prevent fraud by enhancing the quality, timing, and dissemination of disclosure in the municipal securities market.

Underwriting Requirement
Proposed paragraph (b)(5) would prohibit a participating underwriter from purchasing or selling municipal securities in an offering without making a reasonable determination that the issuer or its designated agent has undertaken in a written agreement or contract to provide certain information to a nationally recognized municipal securities information repository (NRMSIR).

The information that must be provided includes:

- Current financial information, at least annually, concerning the issuer of the municipal securities and any significant obligors.

- Timely notice of the following events, if material:

(1) Principal and interest payment delinquencies;

(2) Non-payment related defaults;

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

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

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

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

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Matters affecting collateral; and

(11) Rating changes.

The written agreement or contract also must specify the accounting principles used to prepare the audited financial statements; the financial and pertinent operating information being provided on an annual basis, in addition to audited financial statements; and the time within which the annual information for the preceding year will be provided to the NRMSIR.

Proposed paragraph (b)(5) requires the issuer or its designee to provide financial and operating information on "significant obligors" of an issuer of a municipal security in the final official statement and in annual financial information. The proposed amendments, in paragraph (f)(9), also define the term "significant obligor" as any person who, directly or indirectly, is the source of 20 percent or more of the cash flow servicing the obligations supporting the municipal securities payments of interest or principal.

As proposed, a new paragraph (c) prohibits any broker/dealer from recommending the purchase or sale of a municipal security unless such broker/dealer has reviewed the issuer's information.
The proposed amendment does not specify the form in which information must be reviewed, or which documents must be obtained. The proposed amendment allows participants in the municipal securities market to obtain and review this information through any means of dissemination.

While the information may be available from documents placed in a repository, this may not be the only source of information. Broker/dealers may obtain this information directly from the issuer, from professionals such as attorneys, accountants, or other municipal securities dealers, or from any other reliable source. If, in reviewing this information, they suspect that disclosure is inaccurate or incomplete, or that it requires additional investigation, broker/dealers may need to obtain additional information or seek to verify existing information. If, however, the rating is known and information placed with a repository has been reviewed and raises no questions, a broker/dealer does not need to look further for information about the security recommended.

Exemptions
Consistent with other provisions of Rule 15c2-12, the proposed amendments only apply to primary offerings of municipal securities with an

aggregate principal amount of $1 million or more.

The proposed amendments include a new exemption in paragraph (d)(2) that provides, in addition to the $1 million threshold applicable to Rule 15c2-12 generally, that offerings would be exempt if, at such time as the issuer of municipal securities delivers the securities to the participating underwriter, the issuer: (a) will have less than $10 million in aggregate amount of municipal securities outstanding, including the offered securities; and (b) the issuer will have issued less than $3 million in aggregate amount of municipal securities in the 48 months preceding the offering.

This exemption is designed to exclude small issuers that do not frequently issue municipal securities.

The proposed amendments also include a new exemption in paragraph (d)(3) to permit recommendations in the secondary market of securities that were not subject to the disclosure requirements in paragraph (b)(5), either because they were sold in a primary offering of municipal securities with an aggregate principal amount of less than $1 million, or because they came within the existing exemptions under newly designated paragraph (d)(1) for limited placements, short-term securities, and securities with demand features, or within the exemption in new paragraph (d)(2) for small, infrequent issuers.

Transitional Provision

Newly designated paragraph (g) of the rule contains a transitional provision for the proposed amendments, under which the provisions of paragraph (b)(5) apply to a participating underwriter that had contractually committed to act as an underwriter in an offering on or after the effective date of the rule change.

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NASD members that conduct a municipal securities business are urged to review the SEC's interpretive statement in its entirety. A copy of the statement follows this Notice. The SEC is seeking comments on these issues and possible future action. The SEC also is requesting comment on the proposed amendments to Rule 15c2-12.

Members that wish to comment on either the interpretive statement or the Rule 15c2-12 proposed amendments should do so by July 15, 1994. Comment letters should refer to File No. S7-4-94 (Interpretive Statement) and File No. S7-5-94 (Rule 15c2-12 proposed rulemaking) and should be sent, in triplicate, to:

Jonathan G. Katz
Secretary
SEC
450 Fifth Street, N.W.
Washington, D.C. 20549

Members are requested to send copies of their comment letters to:

Joan Conley
Corporate Secretary
NASD
1735 K Street, N.W.
Washington, D.C. 20006-1500

Questions concerning this Notice may be directed to Brad Darfler, District Coordinator, Compliance Department, (202) 728-8946.