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INVESTMENT COMPANY INSTITUTE
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Comment Letter on MSRB Rule Concerning Pay-to-Play Practices, October 2001

October 5, 2001

Jill C. Finder, Esquire
Assistant General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

Re: MSRB Notice: MSRB Review of Rule G-37

Dear Ms. Finder:

The Investment Company Institute[1] appreciates the opportunity to express its views on the recent Notice published by the Municipal Securities Rulemaking Board soliciting comment on Rule G-37, which relates to political contributions and prohibitions on municipal securities business.[2] While the MSRB has sought comment on all aspects of the rule, the Institute's comments are limited to the impact of the rule's prohibitions on dealers involved in the distribution of municipal fund securities. In particular, and as discussed in more detail below, the Institute recommends that the MSRB revise the rule to provide municipal fund security dealers the opportunity to "cure" inadvertent violations of the rule and to limit application of the rule's two-year look back provision.

I. Overview of Rule G-37

Generally speaking, Rule G-37 prohibits a dealer from engaging in municipal securities business with an issuer within two years after certain contributions to an official of such issuer made by the dealer, any municipal finance professional (MFP) associated with such dealer (other than certain de minimis contributions), or any political action committee controlled by the dealer or any MFP. In addition to being applied prospectively, the rule has a two-year look back period. Under this look-back, a non-de minimis contribution to an issuer official made by an individual while he or she is not an MFP would nonetheless cause a dealer to be banned from municipal securities business with the issuer if the individual becomes associated with the dealer as an MFP during the two-year period following the contribution. The provisions of Rule G-37 were intended to address concerns over dealers being awarded municipal securities business based on their political contributions and to eliminate a potential conflict of interest, or the appearance of a conflict of interest, when dealers make contributions to officials responsible for or capable of influencing the awarding of municipal securities business. The two-year look back provision was intended to prohibit a dealer from obtaining municipal securities business based on prior contributions by individuals now acting as municipal finance professionals for the dealer.

II. Rule G-37 Is Overly Broad as Applied to Municipal Fund Securities

A. Application to Section 529 Program Contracts

In January 2001, the MSRB amended its rules to provide for the regulation of a new type of municipal security – municipal fund securities.[3] A significant distinction between traditional municipal securities and municipal fund securities relevant to the application of Rule G-37 is that offerings of traditional municipal securities are typically discrete events; while offerings of municipal fund securities are continuous. This is significant because it impacts the nature of the contracts executed between the issuer of municipal fund securities and the Section 529 program manager.[4] Indeed, to ensure continuity in the operation of a Section 529 program, it is not unusual for the contract between a state and the program manager to have a multi-year term with renewal provisions.[5]

The application of Rule G-37 in its current form to those municipal securities dealers that distribute municipal fund securities in connection with a Section 529 program is inappropriate because the consequences of an unintended violation of the rule, compared to the case of a dealer of traditional municipal securities, are far more punitive and will negatively impact many innocent parties.[6]

These innocent parties include the Section 529 program, the program's issuer (the state) and the program's account holders.

Because Section 529 program managers typically rely upon affiliated broker-dealers to assist in the distribution of municipal fund securities, a violation of Rule G-37 could have the practical effect of forcing both the program manager and the municipal fund securities dealer to sever their ongoing involvement with the program, thereby disrupting the performance of any duties required of such person(s) under the program contract. In effect, because of the extensive obligations typically required under a Section 529 program contract, a Rule G-37 violation effectively could result in a wholesale replacement of one Section 529 program with a new program.

Section 529 programs typically involve the issuer outsourcing extensive functions that are necessary to operate and administer the program over several years.[7] These are functions that a state would not practically be in a position to assume itself. Thus, in the event of a violation of Rule G-37, the state may have to assign to another program manager, distributor (i.e., municipal securities dealer), or service provider—a process that may be subject to various state regulatory requirements and one that could not be accomplished overnight. This process most likely would place significant administrative and supervisory burdens on the state.

Account holders in these programs would be severely burdened by such a change. First, the account holders would be advised that a significant change in the Section 529 program was under way. Most likely, detailed information regarding new program choices would need to be reviewed and understood. Then, account holders would need to decide which investment alternative to select. Where the investment alternatives provided under the original and the replacement Section 529 programs vary, this selection process might be difficult or confusing for account holders. Any requirement to act within a specified period of time could add to these burdens. Moreover, throughout the change-over period from the original Section 529 program to the replacement program (and even thereafter), account holders might experience difficulty obtaining the customer services that previously were readily available from the Section 529 program.[8]

The practical effect of a violation of Rule G-37 also would be more punitive to a dealer in municipal fund securities than to a dealer of traditional municipal securities. In the case of a dealer of traditional municipal securities, a violation of Rule G-37 would mean that it would be precluded from underwriting any municipal securities or engaging in municipal securities business with that issuer for two years; after this period, the dealer would again be eligible to bid on and underwrite new deals and sell municipal securities. In contrast, because of the limited number, and long-term nature, of Section 529 program arrangements—which results in them not being subjected to public bid as often as traditional municipal securities—the practical effect of a Rule G-37 violation on a dealer in municipal fund securities would likely be far longer than two years.

To address these concerns, the Institute recommends that the MSRB revise Rule G-37 to permit a municipal dealer that is subject to the provisions of Rule G-37 due to its distribution of municipal fund securities to "cure" certain limited violations of the rule. In particular, we recommend that the rule be revised to provide an exemption from the rule's two year prohibition with respect to municipal fund securities activities if: (i) upon discovering that a contribution has been made that would be prohibited under Rule G-37, the dealer actively pursues its return; and (ii) the dealer's report to the Board pursuant to Rule G-38 includes information concerning its reliance on this exemption. Such a provision would preserve the interest of the MSRB in addressing concerns with pay-to-play practices in connection with Section 529 programs, while avoiding the unduly harsh consequences noted above.

B. The Reach of the Two-Year Look Back Provision

The reach of the two-year look back provision of Rule G-37 as it applies to MFPs of a municipal fund securities dealer is similarly unnecessarily harsh in light of the fact that municipal fund securities are offered on a continuous basis. For example, assume seven years into a municipal fund security contract between a program sponsor and a state, the dealer wishes to hire an MFP that made a political contribution the previous year that would not qualify for the de minimis exemption in Rule G-37. Under Rule G-37, the dealer would have two choices: not hire the individual in a capacity that would qualify the person as an MFP or terminate its participation in the state's Section 529 program. In this example, it is highly unlikely that the potential MFP's contribution had any influence or even the appearance of any influence in the program sponsor being awarded the Section 529 program contract seven years previously. And yet, because of the absolute nature of Rule G-37's two-year look-back provision and the on-going nature of the Section 529 offering, the rule would capture activity that could not fairly be characterized as "pay-to-play" and, thus, would not be consistent with the rule's original purpose.

To address this concern, the Institute strongly recommends that the MSRB revise the two-year look back provision with respect to municipal fund securities to apply only in those instances in which a political contribution would most likely be expected to impact the dealer's selection for participation in the program. In particular, we recommend that, with respect to a municipal fund securities dealer, the look back provision only apply to those contributions made during the two-year period preceding the award—including the initial award or any renewal—of any municipal fund security contract by the issuer. Such a provision would enable dealers in municipal fund securities to hire persons who have made political contributions where such contributions almost certainly had no impact on the award of business to the dealer with which the MFP is associated. As the same time, it would preserve the prohibitions

provided under Rule G-37 that preclude political contributions that might be perceived as attempting to influence the awarding of a Section 529 program contract.

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The Institute appreciates the opportunity to provide these comments on MSRB Rule G-37. If you have any questions concerning them or would like any additional information, please contact Tami Reed of the Institute at (202) 326-5825 or the undersigned at (202) 326-5815.

Sincerely,

Craig S. Tyle
General Counsel

cc: Diane G. Klinke, Esquire

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes8,710 open-end investment companies ("mutual funds"), 481 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.673trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] See MSRB Review of Rule G-37, published by the MSRB on June 4, 2001.

[3] While the term “municipal fund securities” as defined in MSRB Rule D-12 includes both local government investment pools and Section 529 college savings plans, the concerns expressed in this letter refer only to those municipal fund securities that are Section 529 college savings plans.

[4] The municipal securities dealer that acts as the distributor of a Section 529 program is often an affiliate of the program manager.

[5] See, e.g., the programs offered by Arkansas (10 year contract with Mercury Funds); Maine (15 year contract with Merrill Lynch); and Alaska (15 year contract with T. Rowe Price).

[6] In addition, consistent with the purpose behind Rule G-37, it seems inappropriate to include within the scope of this rule a selling firm or dealer that is neither a party to nor had any involvement in the contract between the municipal fund issuer and the program manager. For example, it is not unusual for the program manager awarded the state contract to, in turn, contract with other selling firms in order to distribute the municipal fund securities. When these selling firms are not parties to the contract with the state and had no involvement in the awarding of the contract with the state, it seems contrary to the intent of Rule G-37 to subject them to this rule merely because of their status as selling dealers. The Institute recommends that Rule G-37 be revised or interpreted to exclude such selling dealers from the scope of the rule.

[7] A typical Section 529 program contract provides for the complete administration and operation of the State’s program including, for example, preparing the offering documents, marketing and distributing the municipal fund securities, investing the resulting contributions made by plan participants, providing customer service, recordkeeping, and performing transfer agent and back office services.

[8] By comparison, the provisions in Rule G-37 that would require a dealer in traditional municipal securities to sever ties with an issuer due to a violation of Rule G-37 would likely have little, if any, impact on those persons holding securities of the issuer.