

Comment Letter on MSRB Rule Regarding Responsibility of Brokers, Dealers, October 2001

October 19, 2001

Ms. Carolyn Walsh
Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314-3412

Re: Notice and Draft Interpretive Guidance on Rule G-17– Disclosure of Material Facts and Interpretive Guidance Concerning Sophisticated Municipal Market Professionals

Dear Ms. Walsh:

The Investment Company Institute¹ appreciates the opportunity to comment on the Municipal Securities Rulemaking Board's revised notice and draft interpretive guidance regarding the responsibilities of brokers, dealers and municipal securities dealers (collectively, dealers) under MSRB Rule G-17 (disclosure of material facts), and the application of MSRB rules to transactions with sophisticated municipal market professionals.² The MSRB's overall objective in providing interpretive guidance in this area is to allow electronic trading systems to develop for municipal securities without in any way diminishing the current level of customer protection standards now required by MSRB rules. The Institute supports this objective. We had serious concerns with the initial draft guidance issued by the MSRB last September, particularly with respect to the reduction of dealers' disclosure obligations and investor protections without any appropriate limitations.³ The Institute is pleased that the Revised Draft Guidance addresses many of our concerns. Our support of the Revised Draft Guidance is conditioned, however, on it being applied in the limited manner intended by the MSRB and in a manner consistent with our comments below.

Background

In the 2000 Draft Guidance, the MSRB introduced a new concept, the "sophisticated market professional" (or SMP), that would be used to define a certain class of investor. The 2000 Draft Guidance proposed to reduce obligations on dealers under certain MSRB rules if the dealer determined that a customer is an SMP.⁴ The Institute submitted a comment letter objecting to the proposal, in particular because it was based on the flawed premises that the disclosure regime applicable to municipal securities is comparable to that of securities of operating companies that report under the Securities Act of 1934, and that certain categories of investors routinely enjoy timely access to all material information on municipal securities that is available to brokers.⁵

In response to our concerns, as well as those expressed by others, the MSRB has determined to modify the SMP proposal, which, under the new proposal, would be called a "sophisticated municipal market professional" (or SMMP). Under the Revised Draft Guidance, the SMMP concept would only apply when a dealer is effecting non-recommended secondary market transactions for a customer. The Institute supports the MSRB's proposal to limit the SMMP concept in this manner.⁶ This modification recognizes that the existing disclosure system in the municipal securities market is not as robust as the disclosure system in the equity market and that it is important that any reduction in a dealer's disclosure obligations not lead to reductions in investor protections. Consistent with this, we believe it is important that the SMMP concept be narrowly interpreted to ensure that all investors have timely access to material information to enable an informed investment decision.⁷ To that end, our recommendations on the Revised Draft Guidance are intended to ensure that any dealer reliance on the proposed SMMP safe harbor is appropriate. Our comments follow.

1. The SMMP Concept Should be Limited to Electronic Trading Platforms

The Revised Draft Guidance states that the SMMP proposal is intended primarily to allow the development of cost efficient electronic trading platforms.⁸ The Revised Draft Guidance further states, however, that the concept is applicable to all non-recommended

secondary market municipal securities transactions. The Institute recommends that the SMMP concept be restricted to electronic trading platforms.

The Institute supports appropriate initiatives to promote electronic trading in the municipal securities market. While we agree with the MSRB's position that it is appropriate to relieve dealers operating electronic trading platforms of their affirmative disclosure obligations under Rule G-17 for the limited purpose of executing trades in non-recommended secondary market transactions, we do not believe that dealers should be relieved of their disclosure obligations when effecting transactions of such securities generally. There has been no demonstrated need to expand the SMMP concept to non-electronic trading, which to date has successfully operated without it. Accordingly, there is no justification for diluting dealer responsibilities in traditional trading transactions.

2. The SMMP Concept Should Not Apply to Securities Exempt Under Rule 15c2-12

As noted above, the scope of the SMMP concept, as proposed, would extend to any dealer who effects non-recommended secondary market transactions for a customer. Excluded from this safe harbor, however, are dealers who effect transactions in new issue securities, or who recommend a security transaction. The Institute supports these exclusions but recommends that the safe harbor be further modified to exclude dealers who effect transactions in private placement securities and securities exempt from the disclosure requirements of Rule 15c2-12 under the Securities Exchange Act of 1934, such as variable rate demand obligations (collectively, Exempt Securities). The premise underlying the SMMP concept, i.e., that information about a security is already disclosed generally to the public, is particularly inapplicable to these securities. Because updated information on Exempt Securities is not required, it would be illogical and potentially harmful to investors to permit them to be traded on an electronic platform, where it is presumed that the securities being traded are subject to continuing disclosure obligations. This is particularly important for money market funds given their responsibilities under the Investment Company Act of 1940. Thus, the Revised Draft Guidance should be modified to make clear that the SMMP safe harbor does not extend to dealers who effect transactions in Exempt Securities.

3. Dealers' Duty Not To Mislead Customers

The Revised Draft Guidance explains that the SMMP concept is designed to enable the development of electronic platforms that will "allow dealers to be 'order-takers' when effecting non-recommended secondary market transactions in all types of municipal securities."⁹ The Revised Draft Guidance also clarifies that the SMMP concept does nothing to alter a dealer's duty not to engage in deceptive, dishonest, or unfair practices under Rule G-17 or under the federal securities laws. To underscore the point, the Revised Draft Guidance notes that a dealer's intentional withholding of material information about a security that is otherwise not accessible through established industry sources, may constitute an unfair practice, and emphasizes that a dealer may not knowingly misdescribe securities to a customer. The Institute supports this position. We recommend that the MSRB reiterate in its final guidance that the SMMP concept does not in any way diminish a dealer's affirmative disclosure obligations under Rule G-17. Reminding dealers who seek to rely on the SMMP safe harbor of their duty not to mislead customers serves to reinforce the importance of full and fair disclosure in municipal securities transactions. Moreover, such a reminder will go far in helping to ensure that no material information is inadvertently withheld from their customers that is not generally available to the market.

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The Institute appreciates the opportunity to comment on the MSRB's Revised Draft Guidance. If you have any questions or need additional information, please contact me at (202) 326-5824 or Barry Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,710 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 \$6.673 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

² Notice and Draft Interpretive Guidance on Rule G-17—Disclosure of Material Facts and Interpretive Guidance Concerning Sophisticated Municipal Market Professionals (July 6, 2001) (Revised Draft Guidance). In addition to Rule G-17, the SMMP concept may be applied to Rule G-18—Duty to Ensure that Agency Transactions are Effected at Fair and Reasonable Prices, Rule G-19—Suitability of Recommendations and Transactions, and Rule G-13—Quotations.

³ Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions (September 28, 2000) (2000 Draft Guidance).

⁴ Under the 2000 Draft Guidance, a dealer could categorize a customer as an SMP if the dealer determined that the customer (1) has timely access to all publicly available material facts concerning a transaction, (2) is capable of independently evaluating the investment risk and market value of the securities at issue, and (3) makes independent investment decisions.

⁵ See Letter from Amy B. R. Lancellotta, Senior Counsel, Investment Company Institute, to Ernesto A. Lanza, Associate General Counsel, MSRB, dated November 30, 2000.

⁶ In addition, the MSRB made several other revisions to the SMMP concept, including clarifying that individuals should not be considered to be SMMPs and requiring that the application of the SMMP concept closely adhere to the language in the National Association of Securities Dealers' rule on suitability obligations to institutional customers. See NASD IM-2310-3 "Suitability Obligations to Institutional Customers." Moreover, the MSRB has limited the application of the SMMP concept to institutions with at least \$100 million invested in municipal securities in the aggregate and/or under management.

⁷ The Revised Draft Guidance notes that electronic trading platforms are not designed either to describe the risks inherent in the municipal securities market to the platform participants, or to supply participants with extensive information about the securities being traded. See Revised Draft Guidance at 5.

⁸ Id.

⁹ See Revised Draft Guidance at 5.