

NASD NOTICE TO MEMBERS 97-51

NASD Regulation Grants Two Conditional Exemptions Under MSRB Rule G-37

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- ☐ Government Securities
- ☐ Institutional
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☒ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☒ Training

Executive Summary

Under SEC approved procedures, NASD Regulation, Inc. (NASD RegulationSM) reviews member requests for exemption from the two-year prohibition of municipal securities underwriting business contained in Rule G-37 (Rule) of the Municipal Securities Rulemaking Board (MSRB). Recently, NASD Regulation granted two conditional exemptions under exemption paragraph (i) of the Rule. The two conditional exemptions were granted in light of the highly unusual facts and circumstances of the particular cases, and reflect the MSRB's expressed intent that dealers would not routinely request exemptions and that NASD Regulation would grant exemptions only in very limited circumstances.

The two conditional exemptions and NASD Regulation's rationale for its determinations are summarized in this *Notice*. These exemptions should not be viewed as precedents for other requests. Rather, NASD Regulation has determined to provide notice of its responses to selected exemption requests in order to highlight the procedures that all members should institute to avoid triggering the two-year business prohibition under the Rule. Members should be aware that future requests for exemptions under the Rule will be reviewed on an individual basis and granted only in limited cases. Dealers should continue to ensure that their compliance procedures are reasonably designed and implemented to avoid triggering the two-year prohibition.

Background

The Rule prohibits a broker, dealer or municipal securities dealer (dealer) from engaging in municipal securities business with an issuer for two years after the dealer, any municipal finance professional (MFP) associated with the dealer, or any political action committee (PAC) controlled

by the dealer or any such associated MFP, makes a contribution to any official of the issuer who can, directly or indirectly, influence the awarding of municipal securities business. The only contributions to such an issuer official that do not trigger a prohibition on municipal securities business are contributions by an MFP to an official of an issuer for whom the MFP is entitled to vote that, in total, do not exceed \$250 per election.

Paragraph (i) of the Rule provides NASD Regulation with authority to exempt, conditionally or unconditionally, in particular cases, a dealer from the two-year prohibition on conducting municipal securities business with an issuer following political contributions by municipal securities professionals to specified officials of the issuer.

The MSRB has stated that a dealer who was subject to the prohibition should have to make a substantial showing to be exempted from that prohibition. The MSRB also has stated that it expects the exemption would not be routinely requested by dealers and that exemptions would be granted by the National Association of Securities Dealers, Inc. (NASD[®]) only in limited circumstances.

In connection with the adoption of paragraph (i) of the Rule, the MSRB stated that relief would be appropriate in certain circumstances, such as the following examples raised by public commenters: (1) contributions by a disgruntled employee made purposely to injure the dealer, its management or employees; and (2) a number of small contributions during an election cycle (*e.g.*, over four years) made by an MFP eligible to vote for a particular official of an issuer which, when consolidated, amount to slightly over the \$250 *de minimis* exemption (*e.g.*, \$255).

In determining whether to grant an exemption, the Rule requires that the NASD consider, among other factors, whether: (1) such exemption is consistent with the public interest, the protection of investors and the purposes of the Rule; and, (2) such dealer (A) prior to the time the contribution(s) which resulted in such prohibition was made, had developed and instituted procedures reasonably designed to ensure compliance with the Rule; (B) prior to or at the time the contribution(s) which resulted in such prohibition was made, had no actual knowledge of the contribution(s); (C) had taken all available steps to cause the person or persons involved in making the contribution(s) which resulted in such prohibition to obtain a return of the contribution(s); and (D) had taken such other remedial or preventive measures, as may be appropriate under the circumstances.

History Of Rule G-37 Exemptions Under Current NASD Regulation Review Procedures

On October 20, 1995, the SEC approved NASD procedures for exemption requests under paragraph (i) of the Rule.¹ For details of those procedures, refer to *Notice to Members 95-103*, (December 1995). Since that time, NASD Regulation has received only a limited number of exemption requests. Under these procedures, NASD Regulation has granted only two conditional exemptions, and has not granted any full exemptions.

Under the NASD procedures, exemption requests made pursuant to paragraph (i) of the Rule were submitted to NASD Regulation staff. If an exemption request was denied by NASD Regulation staff, it could be reviewed by the NASD Regulation Fixed Income Committee (the Committee) upon request. The two condi-

tional exemptions were Committee determinations.

The circumstances surrounding the two conditional exemptions as well as the Committee's rationale for its determinations are summarized below. The conditional exemptions were granted for very unusual circumstances, and reflect the MSRB's expressed intent that such exemptions would not be routinely requested by dealers and that exemptions would be granted only in limited circumstances.

Exemption Request #1

Circumstances Surrounding The Request

In May of 1996, the chairman of a dealer wrote a check for \$240 to an elected official of a municipality, who was running for re-election. In July of the same year, the chairman inadvertently mailed a duplicative check for \$240 to the official's campaign, resulting in a total of \$480 being contributed to the official's campaign. This second contribution, in aggregate with the first contribution, triggered the two-year business prohibition under the Rule.

Upon realizing that he had made the same contribution twice, the chairman requested and received a refund check of \$240 from the official's campaign. The chairman stated in an affidavit that at the time he wrote the check, he did not recall having already written a check for the \$240 contribution.

At that time, the dealer's written political contributions policy had required that municipal finance professionals submit a pre-clearance request form to the firm's designated supervisory professional and receive written approval prior to making a contribution. The chairman, in fact, submitted forms in both instances

and received approval of both of his pre-clearance forms.

According to representations made by the dealer, the dealer's designated supervisory principal, at the time the contributions were made, had delegated the responsibility of maintaining the books and records required by MSRB Rule G-8 and G-9 to the dealer's general counsel, who maintained a database of all political contributions by firm personnel. Normally, a pre-request form was reviewed by the general counsel, who compared it against the dealer's database for previous contributions, prior to the delegated supervisory principal's review of the form for approval.

Under the circumstances at issue, the chairman's pre-request form for the first contribution was pre-reviewed by the general counsel, but the pre-request form for the second contribution was approved by the designated supervisory principal, without the general counsel's review. The designated supervisory principal did not remember previously approving a request form for the chairman, but instead relied only on the chairman's indication on the pre-request form that no prior contributions were made to the candidate.

The dealer has subsequently revised its compliance procedures to require that, prior to the designated supervisory principal's review of any request form, the general counsel will review the firm's political contribution database to ensure that the applicant had made no prior contributions to that candidate and to indicate approval or disapproval on the request form.

Committee Determination

The Committee granted the dealer a conditional exemption by reducing the two-year prohibition to one year

from the date of the chairman's second contribution. The Committee found that mitigating factors distinguished the contribution made by the chairman from the contributions seen in other requests before the Committee. The Committee found that the second contribution resulted more from human error by the chairman than from insufficient compliance procedures, failure by the dealer to educate key personnel, or any ignorance by firm personnel of the Rule. The Committee considered the relevant mitigating factors to be that the chairman was knowledgeable of the Rule's requirements and did follow the firm's pre-screening compliance procedures by submitting a second request which, were it not for administrative error, would have prevented the inadvertent second contribution. The Committee also noted that the dealer had already experienced a significant loss of business because of this matter.

Exemption Request #2

Circumstances Surrounding The Request

In 1997, the parent company of a dealer acquired a non-member sponsor of municipal open-ended funds (the acquired company). Upon completion of the acquisition, the chairman and Chief Executive Officer (CEO) of the acquired company became an executive vice president of the dealer and was placed on the dealer's Executive Committee. Under the Rule, the CEO became a municipal finance professional (MFP) of the dealer by virtue of becoming a member of the dealer's Executive Committee. After the acquisition, the dealer discovered that the CEO had made a \$500 contribution to the governor of a particular state in 1996, which triggered the two-year business prohibition under the Rule for the dealer in that state, beginning from the date of the contribution.

The dealer had a long-standing policy forbidding political contributions of any kind by the firm or its employees for the purpose of influencing the municipal securities business. However, according to the dealer, the persons responsible for examining the acquisition of the acquired company did not anticipate that the CEO would become a member of the dealer's Executive Committee.

Committee Determination

The Committee granted the dealer a conditional exemption by reducing the two-year prohibition to one year from the date of the executive's contribution. In reviewing the circumstances surrounding the dealer's request, the Committee found that the placement of the CEO on the dealer's Executive Committee did trigger the two-year prohibition.

To determine the appropriateness of granting a conditional or unconditional exemption under the circumstances at issue, the Committee considered the five factors required to be considered under paragraph (i) of the Rule, and in particular, the first factor, i.e., whether an exemption under the circumstances would be consistent with the public interest, the protection of investors and the purposes of the Rule.

Upon review, the Committee determined that the dealer had: (1) developed and instituted procedures reasonably designed to ensure compliance with the Rule; (2) had no actual knowledge of the contribution prior to or at the time of the contribution; (3) had taken all available steps to cause the person involved in making the contribution to obtain a return of the contribution; and (4) had taken such other remedial or preventative measures as were appropriate under the circumstances. The Committee further noted that the two-year prohibition did not occur from a lack of

knowledge of the Rule by the persons responsible for examining the acquisition of the acquired company, but from a lack of communication to such persons regarding the intent to place the CEO on the Executive Committee.

The Committee determined that, in light of the unusual circumstances, prohibiting the dealer from conducting business in the state in question for one year would constitute a significant penalty that would discourage similar occurrences by the dealer and other dealers.

NASD Regulation notes, however, that the conditional exemption was based on unique and unusual circumstances, including the circumstances surrounding the acquisition and placement of the CEO on the dealer's Executive Committee. This decision should not be construed to mean that a conditional exemption will be granted in future requests if the event which causes the two-year prohibition was inadvertent.

Summary

Members should be aware that future requests for exemptions from the two-year prohibition that are based on circumstances similar to those summarized in this *Notice* may not merit conditional exemptions. Dealers, therefore, should review the circumstances surrounding these two conditional exemptions, and should revise their compliance procedures, if appropriate, to ensure that such procedures are reasonably designed to prevent similar occurrences.

Questions regarding this *Notice* may be directed to John H. Pilcher, Assistant General Counsel, Office of General Counsel, at (202) 728-8287.

Endnotes

¹ These procedures were recently superseded by new Rules 9600 to 9630 of the Code of

Procedure (the Code). On August 7, 1997, the SEC approved new NASD Regulation review procedures for exemption requests under the Rule. See, SEC Rel. No. 34-38908 (August 7, 1997). Under new Rule 9610 of the Code, a member seeking an exemption from the Rule shall file a written application with the Office of General Counsel of NASD Regulation. After considering an application, NASD Regulation staff shall issue a written decision, pursuant to new Rule 9620 of the Code, setting forth its findings and conclusions. The decision shall be served on the applicant pursuant to new Rules 9132 and 9134. After the decision is served on the applicant, the application and decision shall be publicly available unless NASD Regulation staff determines that the applicant has shown good cause for treating the application as confidential in whole or in part.

If the application is denied, an applicant may file a written notice of appeal, pursuant to new Rule 9630, within 15 calendar days after service of a staff decision. The appeal will be reviewed by the National Business Conduct Committee pursuant to new Rule 9630.

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