

Municipal Securities

FINRA Reminds Firms of Their Sales Practice and Due Diligence Obligations When Selling Municipal Securities in the Secondary Market

Executive Summary

Brokers, dealers and municipal securities dealers (dealers) must fully understand the municipal securities they sell in order to meet their disclosure, suitability and pricing obligations under the rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws. These obligations are not limited to firms involved in primary offerings. Dealers must also obtain, analyze and disclose all material facts about secondary market transactions that are known to the dealer, or that are reasonably accessible to the market through established industry sources.

Those sources include, among other things, official statements, continuing disclosures, trade data and other information made available through the MSRB's Electronic Municipal Market Access system (EMMA). Firms may also have a duty to obtain and disclose information that is not available through EMMA, if it is material and available through other public sources. The public availability of material information, through EMMA or otherwise, does not relieve a firm of its duty to disclose that information. Firms must also have reasonable grounds for determining that a recommendation is suitable based on information available from the issuer of the security or otherwise. Firms must use this information to determine the prevailing market price of a security as the basis for establishing a fair price in a transaction with a customer. To meet these requirements, firms must perform an independent analysis of the securities they sell, and may not rely solely on a security's credit rating.

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Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Municipal Securities
- Registered Representatives
- Senior Management

Key Topic(s)

- Credit Ratings
- Disclosure
- EMMA
- Municipal Securities
- Suitability
- Supervision

Referenced Rules & Notices

- Exchange Act Rule 15c2-12
- FINRA Regulatory Notice 09-35
- MSRB Rule G-15
- MSRB Rule G-17
- MSRB Rule G-19
- MSRB Rule G-27
- MSRB Rule G-30
- MSRB Rule G-32
- MSRB Notice 2004-3
- MSRB Notice 2005-01
- MSRB Notice 2007-17
- MSRB Notice 2009-41
- MSRB Notice 2009-42
- MSRB Interpretation of March 4, 1986
- MSRB Interpretation of June 12, 1995

Continuing disclosures made by issuers to the MSRB via EMMA are part of the information that dealers must obtain, disclose and consider in meeting their regulatory obligations. The Securities and Exchange Commission (SEC) has recently approved amendments to Securities Exchange Act Rule 15c2-12, governing continuing disclosures. Firms that sell municipal securities should review and, if necessary, update their procedures to reflect the amendments, which have a compliance date of December 1, 2010.

Questions concerning this *Notice* should be directed to FINRA's Member Regulation Fixed Income Group at (202) 728-8085 or (202) 728-8133.

For information about compliance with MSRB rules, including the recent amendments to Rule 15c2-12, contact FINRA at the numbers above, or the MSRB at (703) 797-6600.

Background and Discussion

MSRB Disclosure, Suitability and Pricing Rules

MSRB Rule G-17 provides that, in the conduct of its municipal securities activities, each dealer must deal fairly with all persons and may not engage in any deceptive, dishonest or unfair practice. The MSRB has interpreted its Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale, all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.¹ This includes the obligation to give customers a complete description of the security, including a description of the features that likely would be considered significant by a reasonable investor and facts that are material to assessing the potential risks of the investment.

Such disclosures must be made at the "time of trade," which the MSRB defines as at or before the point at which the investor and the dealer agree to make the trade. MSRB Rule G-17 applies to all sales of municipal securities, whether or not a transaction was recommended by a broker-dealer.² This means that municipal securities dealers must disclose all information required to be disclosed by the rule even if the trade is self-directed.³

MSRB Rule G-19 requires that a dealer that recommends a municipal securities transaction have reasonable grounds for believing that the recommendation is suitable for the customer based upon information available from the issuer of the security or otherwise and the facts disclosed by, or otherwise known about, the customer.⁴

MSRB Rule G-30 requires that dealers trade with customers at prices that are fair and reasonable, taking into consideration all relevant factors.⁵ The MSRB has stated that the concept of a “fair and reasonable” price includes the concept that the price must “bear a reasonable relationship to the prevailing market price of the security.” The impetus for the MSRB’s Real-time Transaction Reporting System (RTRS), which was implemented in January 2005, was to allow market participants to monitor market price levels on a real-time basis and thus assist them in identifying changes in market prices that may have been caused by news or market events.⁶ The MSRB now makes the transaction data reported to RTRS available to the public through EMMA.

In meeting these disclosure, suitability and pricing obligations, firms must take into account all material information that is known to the firm or that is available through “established industry sources,” including official statements, continuing disclosures, and trade data, much of which is now available through EMMA. Resources outside of EMMA may include press releases, research reports and other data provided by independent sources. Established industry sources can also include material event notices and other data filed with former nationally recognized municipal securities information repositories (NRMSIRs) before July 1, 2009.⁷ Therefore, firms should review their policies and procedures for obtaining material information about the municipal securities they sell to make sure they are reasonably designed to access all material information that is available, whether through EMMA or other established industry sources. The MSRB has also noted that the fact that material information is publicly available through EMMA does not relieve a firm of its duty to specifically disclose it to the customer at the time of trade, or to consider it in determining the suitability of a security for a specific customer.⁸ Importantly, the dealer may not simply direct the customer to EMMA to fulfill its time-of-trade disclosure obligations under MSRB Rule G-17.⁹

Amendments to Rule 15c2-12 Concerning Continuing Disclosure

Securities Exchange Act Rule 15c2-12 requires underwriters participating in municipal securities offerings that are subject to that rule¹⁰ to receive, review, and distribute official statements of issuers of primary municipal securities offerings, and prohibits underwriters from purchasing or selling municipal securities covered by the rule unless they have first reasonably determined that the issuer or an obligated person¹¹ has contractually agreed to make certain continuing disclosures to the MSRB, including certain financial information and notice of certain events. The MSRB makes such disclosure public via EMMA.

Financial information to be disclosed under the rule consists of the following:

- annual financial information updating the financial information in the official statement;
- audited financial statements, if available and not included within the annual financial information; and
- notices of failure to provide such financial information on a timely basis.

Currently, the rule enumerates the following as notice events, if material:

- principal and interest payment delinquencies;
- non-payment related defaults;
- unscheduled draws on debt service reserves reflecting financial difficulties;
- unscheduled draws on credit enhancements reflecting financial difficulties;
- substitution of credit or liquidity providers or their failure to perform;
- adverse tax opinions or events affecting the tax-exempt status of the security;
- modifications to rights of security holders;
- bond calls;
- defeasances;
- release, substitution or sale of property securing repayment of the securities; and
- rating changes.

SEA Rule 15c2-12(c) also prohibits any dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive prompt notice of any event notice reported pursuant to the rule. Firms should review any applicable continuing disclosures made available through EMMA and other established industry sources and take such disclosures into account in undertaking its suitability and pricing determinations.

On May 26, 2010, the SEC amended the rule's disclosure obligations, with a compliance date of December 1, 2010, to: (1) apply continuing disclosure requirements to new primary offerings of certain variable rate demand obligations; (2) add four new notice events;¹² (3) remove the materiality standard for certain notice events;¹³ and (4) require that event notices be filed in a timely manner but no later than 10 business days after their occurrence. With respect to the tax status of the security, the rule has been broadened to require disclosure of adverse tax opinions, issuance by the IRS of proposed or final determinations of taxability and other material notices, and determinations or events affecting the tax status of the bonds (including a Notice of Proposed Issue). Firms that deal in municipal securities should familiarize themselves with these amendments, and, if necessary, modify their policies and procedures to incorporate this additional disclosure accordingly.

In addition, as FINRA noted in *Regulatory Notice 09-35*, if a firm discovers through its SEA Rule 15c2-12 procedures or otherwise that an issuer has failed to make filings required under its continuing disclosure agreements, the firm must take this information into consideration in meeting its disclosure obligations under MSRB Rule G-17 and in assessing the suitability of the issuer's securities under MSRB Rule G-19.

Credit Ratings

In order to meet their obligations under MSRB Rules G-17 and G-19, firms must analyze and disclose to customers the risks associated with the securities they sell, including, but not limited to, the security's credit risk. A credit rating is a third-party opinion of the credit quality of a municipal security. While the MSRB generally considers credit ratings and rating changes to be material information for purposes of disclosure, suitability and pricing, they are only one factor to be considered, and dealers should not solely rely on credit ratings as a substitute for their own assessment of a security's credit risk.¹⁴ Moreover, different agencies use different quantitative and qualitative criteria and methodologies to determine their rating opinions. Dealers should familiarize themselves with the rating systems used by rating agencies in order to understand and assess the relevance of a particular rating to the firm's overall assessment of the security.¹⁵

With respect to credit or liquidity enhanced securities, the MSRB has stated that material information includes the following, if known to the dealer or if reasonably available from established industry sources: (1) the credit rating of the issue or lack thereof; (2) the underlying credit rating or lack thereof, (3) the identity of any credit enhancer or liquidity provider; and (4) the credit rating of the credit provider and liquidity provider, including potential rating actions (*e.g.*, downgrade).¹⁶ Additionally, material terms of the credit facility or liquidity facility should be disclosed (*e.g.*, any circumstances under which a standby bond purchase agreement would terminate without a mandatory tender).

Other Material Information

In addition to a security's credit quality, firms must obtain, analyze and disclose other material information about a security, including but not limited to whether the security may be redeemed prior to maturity in-whole, in-part or in extraordinary circumstances,¹⁷ whether the security has non-standard features that may affect price or yield calculations,¹⁸ whether the security was issued with original issue discount or has other features that would affect its tax status,¹⁹ and other key features likely to be considered significant by a reasonable investor. For example, for variable rate demand obligations, auction rate securities or other securities for which interest payments may fluctuate, firms should explain to customers the basis on which periodic interest rate resets are determined.²⁰ The MSRB has stated that firms should take particular care with respect to new products that may be introduced into the municipal securities market, existing products that may have complex structures that can differ materially from issue to issue, and outstanding securities that may trade infrequently, may be issued by less well-known issuers, or may have unusual features.²¹

Supervision

Firms are reminded that MSRB Rule G-27 requires firms to supervise their municipal securities business, and to ensure that they have adequate policies and procedures in place for monitoring the effectiveness of their supervisory systems. Specifically, firms must:

- supervise the conduct of the municipal securities activities of the firm and associated persons to ensure compliance with all MSRB rules, the Exchange Act and the rules there under;
- have adequate written supervisory procedures; and
- implement supervisory controls to ensure that their supervisory procedures are adequate.

MSRB Rule G-27 requires that a firm's supervisory procedures provide for the regular and frequent review and approval by a designated principal of customer accounts introduced or carried by the dealer in which transactions in municipal securities are effected, with such review being designed to ensure that transactions are in accordance with all applicable rules and to detect and prevent irregularities and abuses. Although the rule does not establish a specific procedure for ensuring compliance with the requirement to provide disclosures to customers pursuant to MSRB Rule G-17, firms should consider including in their procedures for reviewing accounts and transactions specific processes for documenting or otherwise ascertaining that such disclosures have been made.

Questions to Consider

Before selling any municipal security, dealers should make sure that they fully understand the security they are selling in order to make adequate disclosure to customers under MSRB Rule G-17, to ensure that recommendations are suitable under MSRB Rule G-19, and to ensure that they are fairly priced under MSRB Rule G-30. Among other things, dealers should ask and be able to answer the following questions:

- What are the security's key terms and features and structural characteristics, including but not limited to its issuer, source of funding (*e.g.*, general obligation or revenue bond), repayment priority, and scheduled repayment rate? Much of this information will be in the Official Statement, which for many municipal securities can be obtained by entering the CUSIP number in the MuniSearch box at www.emma.msrb.org. Be aware, however, data in the Official Statement may have been superseded by the issuer's on-going disclosures.
- Does information available through EMMA or other established industry sources indicate that an issuer is delinquent in its material event notice and other continuing disclosure filings? Delinquencies should be viewed as a red flag.

- What other public material information about the security or its issuer is available through established industry sources other than EMMA?
- What is the security's rating? Has the issuer recently been downgraded? Has the issuer filed any recent default or other event notices, or has any other information become available through established industry sources that might call into question whether the published rating has been revised to take such event into consideration?
- Is the security insured, or does it benefit from liquidity support, a letter of credit or is it otherwise supported by a third party? If so, check the credit rating of the insurer or other backing, and the security's underlying rating (without third party support). If supported by a third party, review the terms and conditions under which the third party support may terminate.
- How is it priced? Be aware that a municipal security can be priced above or below its par value for many reasons, including changes in the creditworthiness of the issuer and prevailing interest rates.
- How and when will interest on the security be paid? For example most municipal bonds pay semiannually, but zero coupon municipal bonds pay all interest at the time the bond matures. Variable rate bonds typically will pay interest more frequently, usually on a monthly basis in variable amounts.
- What is the security's tax status, under both state and federal laws? Is it subject to the Federal Alternate Minimum Tax? Is it fully taxable (e.g., Build America Bonds)?
- What are its call provisions? Call provisions allow the issuer to retire the security before it matures. How would a call affect expected future income?

Endnotes

- 1 MSRB Rule G-17 applies to all transactions in municipal securities, including those in both the primary and secondary market. MSRB Rule G-32 specifically addresses delivery of the official statement in connection with primary offerings.
- 2 See MSRB Notice 2009-42 (July 14, 2009).
- 3 A dealer's specific investor protection obligations, including its disclosure, fair practice and suitability obligations under MSRB Rules G-17 and G-19, may be affected by the status of an institutional investor as a Sophisticated Municipal Market Professional (SMMP). See Rule G-17 Interpretation – Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals (April 30, 2002)
- 4 See MSRB Notice 2009-42, supra n.2.
- 5 Rule G-18 requires that a dealer effecting an agency trade with a customer make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.
- 6 See MSRB Notice 2004-3 (January 26, 2004).
- 7 Since July 1, 2009, material event notices are required to be filed through EMMA, which has replaced Bloomberg Municipal Repository; DPC DATA Inc.; Interactive Data Pricing and Reference Data, Inc.; and Standard & Poor's Securities Evaluations, Inc. as the sole NRMSIR.
- 8 The MSRB has also stated that providing adequate disclosure does not relieve a firm of its suitability obligations. See MSRB Notice 2007-17 (March 30, 2007).
- 9 MSRB Rule G-32 does allow a dealer to satisfy its obligation to deliver an official statement to its customer during the primary offering disclosure period no later than the settlement of the transaction by advising the customer of how to obtain it on EMMA, unless the customer requests a paper copy. The delivery obligation under MSRB Rule G-32 is distinct from the duty to disclose material information under Rule G-17, which applies to all primary and secondary market transactions.
- 10 Certain limited offerings, variable rate demand obligations, and small issues are exempt from SEA Rule 15c2-12.
- 11 "Obligated person" is defined as "any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations of the municipal securities to be sold in the offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities)."
- 12 The new notice events are (1) tender offers, (2) bankruptcy, insolvency, receivership, or similar events, (3) consummation of mergers, consolidations, acquisitions, or asset sales, or entry into or termination of a definitive agreement related to do the same, if material, and (4) appointment of a successor or additional trustee or a change in the name of the trustee, if material.

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Endnotes continued

- 13 The amendments removed the materiality standard and require notices for the following events: (1) principal and interest payment delinquencies with respect to the securities being offered ; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes. The amendments retained the materiality standard for the following events: (1) non-payment related defaults; (2) modifications to rights of security holders; (3) bond calls; and (4) release, substitution, or sale of property securing repayment of the securities.
- 14 See MSRB Notice 2009-42, *supra* n.2. Ratings changes are reportable events under Rule 15c2-12.
- 15 Not all municipal securities are rated. While an absence of a credit rating is not, by itself, a determinant of low credit quality, it is a factor that dealers should consider, and may warrant additional due diligence of the security and its issuer by the dealer. In addition, MSRB Rule G-15 requires confirmation statements for customer trades in unrated municipal securities to disclose that the securities are not rated.
- 16 See MSRB Notice 2009-42. The SEC has approved the MSRB's proposal to require dealers to submit copies of credit enhancement and liquidity facility documents to EMMA pursuant to amended MSRB Rule G-34(c), which may increase the availability of such information to dealers. See Securities Exchange Act Release No. 62755, August 20, 2010 (File No. SR-MSRB-2010-02).
- 17 See Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, MSRB Interpretation of March 4, 1986.
- 18 See Transactions in Municipal Securities With Non-Standard Features Affecting Price/Yield Calculations, MSRB Interpretation of June 12, 1995.
- 19 See MSRB Notice 2005-01 (January 5, 2005); MSRB Notice 2009-41 (July 10, 2009).
- 20 See MSRB Notice 2008-09 (February 19, 2008).
- 21 See MSRB Notice 2009-42, *supra* n.2.