

## SEC Seeks Comment on MSRB Proposed Broker's Broker Rules

The Securities and Exchange Commission (the "SEC") recently released a notice of proposed Municipal Securities Rulemaking Board ("MSRB") rule changes governing the conduct of broker's brokers. The proposed definition of "broker's broker" generally includes a broker, dealer, or municipal securities dealer that principally effects transactions for other broker-dealers or that holds itself out as a broker's broker. The proposed rule changes include:

- new MSRB Rule G-43, which would impose specific duties on municipal securities broker's brokers and require adoption of certain policies and procedures;
- amendments to MSRB Rule G-8 on recordkeeping, MSRB Rule G-9 on record retention, and MSRB Rule G-18 on agency trades and trades by broker's brokers; and
- an interpretive notice on the duties of brokers, dealers, and municipal securities dealers that use the services of broker's brokers.

Comments on the proposal are due 21 days from publication in the Federal Register, which has not yet occurred. The MSRB requested that the proposed rule changes be made effective six months after approval by the SEC. A copy of the SEC release is available at <http://www.sec.gov/rules/sro/msrb/2012/34-66625.pdf> and the text of the proposed rule changes is available at <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-12.aspx>.

### Background

In September 2010, the MSRB requested guidance on the application of existing MSRB rules to broker's brokers, in part as a result of enforcement actions by both the SEC and the Financial Industry Regulatory Authority involving broker's broker activities constituting violations of MSRB rules. In February 2011, the MSRB issued Notice 2011-18 in which it requested comments on draft Rule G-43 (broker's brokers) and draft amendments to Rules G-8 (books and records), G-9 (preservation of records), and G-18 (execution of transactions). For additional information on the original proposal, please see our March 15, 2011 Client Alert available at <http://www.chapman.com/media/news/media.972.pdf>. In September 2011, the MSRB issued revised draft Rule G-43 and amendments to Rules

G-8 and G-9 and sought additional comments. For additional information on the September 2011 rule proposal, please see our October 5, 2011, Client Alert available at <http://www.chapman.com/media/news/media.1085.pdf>. On March 5, 2012, the MSRB submitted a revised proposal to the SEC for final approval. The SEC is now seeking comments on the proposed rule changes, which should be published in the Federal Register in the coming days.

### What is a Broker's Broker?

A broker's broker generally plays the role of acting as an intermediary between other selling dealers and bidding dealers in security transactions. Proposed Rule G-43

defines a “broker’s broker” as a dealer, or a separately operated and supervised division or unit of a dealer, that principally effects transactions for other dealers or that holds itself out as a broker’s broker. For this purpose, the term “dealer” means a broker, dealer, or municipal securities dealer. A broker’s broker can be either an individual company or a part of a company.

Although the original draft Rule G-43 did not address whether a broker’s broker effects trades on a principal basis or an agency basis, various comments raised questions regarding this matter in response to the original proposal. In particular, some comments suggested that a broker’s broker never effects principal transactions. In its September 2011 revisions, the MSRB did not change the draft rule in response to these comments but noted that this language affords broker’s brokers sufficient flexibility and that there is no need to characterize all broker’s broker trades as agency transactions, as they are not all executed in the same manner.

The MSRB expressly rejected a proposed definition of “broker’s broker” submitted by the Securities Industry and Financial Markets Association (“SIFMA”) that would have defined the term to mean a broker, dealer, or municipal securities dealer that:

- acts as a disclosed agent or riskless principal in the purchase or sale of municipal securities for an undisclosed registered broker, dealer, municipal securities dealer, certain “Sophisticated Municipal Market Professionals”, or institutional counterparty;
- does not have or maintain any municipal securities in any proprietary or other accounts, other than for clearance and settlement purposes;
- executes equally matched transactions contemporaneously;
- does not carry any customer accounts;
- does not at any time receive or hold customer funds or safekeep customer securities;
- does not participate in syndicates;
- acts in the limited agency capacity of providing liquidity, market information, order matching, and anonymity through the facilitation of transactions in the interdealer market;
- does not participate in the decision to buy or sell securities, exercise discretion as to the price at which a transaction is executed, or determine the timing of execution; and
- is compensated by a commission, not a mark-up.

The MSRB indicated in its September 2011 proposal that the SIFMA definition would make it easy for a firm to escape classification as a broker’s broker and, accordingly, avoid application of the rules for broker’s brokers. The MSRB noted in September 2011 that the definition of broker’s broker is the appropriate one and is a functional definition that focuses on the key function of a broker’s broker. The MSRB also noted that the alternative clause “or holds itself out as a broker’s broker” was included in the definition because the burden should not be on the selling dealer to know whether a firm holding itself out as a broker’s broker, in fact, principally effects trades for other dealers. Despite further comments to the September 2011 proposal objecting to the MSRB definition, the MSRB kept the function-based definition of “broker’s broker” in the final proposed rule stating that the MSRB continues to be of the view that a function-based definition of “broker’s broker” is appropriate, rather than a detailed list.

In response to comments, the proposed rule does except certain alternative trading systems from the definition of “broker’s broker”; however, in order to qualify for the exception, such systems would be subject to the same prohibitions on abusive behavior as a broker’s broker.

## Basic Duties of a Broker’s Broker

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Proposed Rule G-43 sets forth the basic duties of a broker’s broker to selling dealers and bidding dealers and incorporates the same basic duty currently found in Rule G-18. The proposed revised rule sets forth three basic duties:

- A broker’s broker acting for or on behalf of another dealer in a municipal securities transaction has an obligation to make a reasonable effort to obtain a price for the other dealer that is fair and reasonable in relation to prevailing market conditions. In fulfilling this “pricing duty”, the proposed revised rule requires a broker’s broker to employ the same care and diligence as if the transaction were being done for its own account.

- A broker's broker acting for another dealer in connection with a municipal securities transaction must not take any action that works against that dealer's interest to receive advantageous pricing.
- A broker's broker will be presumed to act for or on behalf of the seller in a "bid-wanted" for municipal securities unless both the seller and bidders agreed otherwise in writing in advance of the bid-wanted. The MSRB removed "offerings" from this duty in response to comments that, in practice, there is not a presumption that a broker's broker is working for the seller of a bond (unlike in a bid wanted). The MSRB also modified this portion of the rule to clarify that a broker's broker may obtain the requisite agreement in advance in a customer agreement rather than on a separate transaction-by-transaction basis.
- Unless otherwise directed by the seller, the broker's broker makes a reasonable effort to disseminate the bid-wanted widely to obtain exposure to multiple dealers with possible interest in the block of securities.
- If securities are of limited interest, the broker's broker must make a reasonable effort to reach dealers with specific knowledge of the issue or known interest in the type of securities being offered.
- The bid-wanted must have a deadline for the acceptance of bids, after which the broker's broker must not accept bids or changes to bids. That deadline can be either a precise ("sharp") deadline or an "around time" deadline as specified in the rule.
- If the high bid received is above or below the predetermined parameters of the broker's broker and the broker's broker believes that the bid may have been submitted in error, the broker's broker may contact the bidder prior to the deadline for bids to determine whether its bid was submitted in error, without having to obtain the consent of the seller.
- If the high bid is within the predetermined parameters but the broker's broker believes that the bid may have been submitted in error, the broker's broker must receive the oral or written permission of the seller before it may contact the bidder to determine whether its bid was submitted in error.
- If the high bid received is below the predetermined parameters, the broker's broker must disclose that fact to the seller, in which case the broker's broker may still effect the trade if the seller acknowledges such disclosure.

A number of the duties applicable to broker's brokers along with policy/procedure and recordkeeping requirements were modified in the final revised proposed rule to clarify that the rules were applicable only to transactions in municipal securities.

The proposed revised rule defines "bid-wanted" as an auction for the sale of municipal securities in which: (a) the seller does not specify a minimum or desired price for the securities that are the subject of the auction at the commencement of the auction; (b) the identities of the bidders and the seller are not disclosed prior to the conclusion of the auction, other than to the broker's broker; (c) bidders must submit bids for the auctioned securities to the broker's broker; and (d) the seller decides whether to accept the winning bid.

The proposed revised rule defines "offering" as a process for the sale of municipal securities in which: (a) the seller specifies a minimum or desired price for the securities as part of the offering, at the offering's commencement; (b) the identities of the seller and the bidders are not disclosed prior to the conclusion of the offering; and (c) a broker's broker negotiates between the seller and the bidders to arrive at a price acceptable to the parties.

### Safe Harbor for Satisfying Pricing Duty for Bid-Wanted

Proposed Rule G-43 includes a safe harbor that provides that a broker's broker will be deemed to satisfy the pricing duty described above with respect to a bid-wanted transaction if it conducts the transaction as follows:

In response to comments, the MSRB removed application of the safe harbor from "offerings" in view of the fact that most offerings are the subject of negotiations among a limited number of parties, unlike bid-wanted, which are generally distributed widely. The MSRB noted in proposing the revised rule that the safe harbor is designed to increase the likelihood that the highest bid in the bid-wanted is fair and reasonable. The MSRB also revised the rule to make many of the provisions which were previously conditions of the safe harbor required policies and procedures applicable whether or not the safe harbor is used.

## Required Policies and Procedures

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Proposed Rule G-43 requires that a broker's broker adopt policies and procedures with respect to operation of bid-wanted and offerings for municipal securities. Broker-dealers are required under the proposed rule to disclose their policies and procedures to sellers of and bidders for municipal securities in writing at least annually and post such policies and procedures in a prominent position on its website. The proposed revised rule provides that, at minimum, such policies and procedures must:

- require the broker's broker to disclose the nature of its undertaking for the seller and bidders in bid-wanted and offerings;
- require the broker's broker to disclose the manner in which it will conduct bid-wanted and offerings;
- require the broker's broker to be compensated on the basis of commissions or other economically similar basis and to provide the seller and bidders with a copy of its compensation schedules, with such schedules reflecting at a minimum the maximum charge that the broker's broker could impose on a transaction;
- if the winning high bidder's bid or the cover bid in a bid-wanted has been changed, require the broker's broker to disclose the change to the seller prior to execution and provide the seller with the original changed bids;
- if a broker's broker allows customers or affiliates to place bids, require the disclosure of that fact to both sellers and bidders in writing and provide for the disclosure to the seller if the high bid in a bid-wanted or offering is from a customer or affiliate of the broker's broker (however the broker's broker is not required to disclose the name of the customer or affiliate);
- if the broker's broker relies on the rule's safe harbor for a bid-wanted, require the broker's broker to adopt predetermined parameters for such bid-wanted, disclose such parameters prominently on its website in advance of the bid-wanted, and periodically test such parameters for effectiveness;
- describe in detail the manner in which the broker's broker will satisfy its obligation under the rule in cases where offerings and bid-wanted are not conducted in accordance with the safe harbor;
- prohibit the broker's broker from maintaining municipal securities in any proprietary or other accounts, other than for clearance and settlement purposes;
- prohibit self-dealing by the broker's broker;
- prohibit a broker's broker from encouraging bids that do not represent the fair market value of municipal securities that are the subject of a bid-wanted or offering;
- prohibit a broker's broker from giving preferential information to bidders in bid wanted (e.g. "last looks," directions to a specific bidder to "review" its bid, etc.);
- prohibit a broker's broker from changing a bid price or offer price without the bidder's or seller's respective permission;
- prohibit a broker's broker from failing to inform the seller of the highest bid in a bid-wanted or offering;
- prohibit a broker's broker from accepting a changed bid or a new bid in the same bid-wanted after the broker's broker has selectively informed a bidder whether its bid is being used in the bid-wanted;
- prohibit the broker's broker from providing any person other than the seller and the winning bidder with information about bid prices, until the bid-wanted has been completed (subject to certain conditions) where a bid-wanted will be completed at the earlier of the security being traded (through the broker's broker or otherwise) and the broker's broker being notified by the seller that the security will not trade.

## Revised Record-Keeping Obligations

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Proposed revised Rules G-8 and G-9 would require each broker's broker to keep certain records with respect to municipal securities activities, including the following:

- all bids to purchase municipal securities together with the time of receipt;
- the time that all offers to sell municipal securities, together with the time the broker's broker first receives the offering and the time the offering is updated for display or distribution;

- the time that (1) high bid is provided to the seller, (2) the seller notifies the broker's broker that it will sell the securities, and (3) the trade is executed;
- for certain safe harbor transactions, specified information regarding each communication with a seller or bidder pursuant to the rule and whether and the extent to which a bid deviated from predetermined parameters;
- for all changed bids, the full name of the person at the bidder that authorized the change and the full name of the person at the broker's broker at whose direction the change was made;
- for all changes in offering price, the full name of the person at the seller that authorized the change and the full name of the person at the broker's broker at whose direction the change was made;
- a copy of any writing by which the seller and bidders agreed to joint representation by the broker's broker;
- a copy of the policies and procedures required under the rule;
- a copy of its predetermined parameters related to reliance on the rule's safe harbor, and information supporting the design of the parameters and testing of the parameters; and
- if a broker's broker trading system is separately operated and supervised division or unit of a broker, dealer or municipal securities dealer, there must be a separately maintained in or separately extractable from such division's or unit's own facilities or the facilities of the broker, dealer or municipal securities dealer, all of the records relating to the activities of the broker's broker or alternative trading system, and such records shall be so maintained or otherwise accessible as to permit independent examination and enforcement of applicable provisions.

The proposed revised rules also provide for certain records that must be maintained by alternative trading systems with respect to its municipal securities activity.

## Draft Interpretive Notice

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In addition to the foregoing rule proposals, the MSRB is proposing an interpretive notice concerning the obligations of brokers, dealers and municipal securities dealers that use the services of a broker's broker. The proposed interpretive notice sets forth the view of the MSRB that, while a bid-wanted or offering conducted in the manner provided in Rule G-43 will be an important element in the establishment of a fair and reasonable price for municipal securities in the secondary market, the failure of selling dealers and bidding dealers to satisfy their pricing duties could negate the best efforts of a broker's broker to achieve fair pricing. The proposed interpretive notice reminds selling dealers that the high bid is not necessarily a fair and reasonable price and that dealers have an independent duty under Rule G-30 to determine that the prices at which they purchase municipal securities as a principal from their customers are fair and reasonable. The proposed interpretive notice also cautions selling dealers that any direction they provide to broker's brokers to "screen" other dealers from their bid-wanted or offerings could affect whether the high bid represents a fair and reasonable price and should be limited to valid business reasons that are not anti-competitive.

The proposed interpretive notice also urges selling dealers not to assume that their customers need to liquidate their securities immediately without inquiring as to their customers' particular circumstances and discussing with their customers the possible improved pricing benefit associated with taking additional time to liquidate their securities. The proposed interpretive notice further provides that the use of bid-wanted by selling dealers solely for price discovery purposes, without any intention of selling the securities through the broker's broker, might be an unfair practice within the meaning of Rule G-17. Under the proposed interpretive notice, bidding dealers that submitted bids to broker's brokers that they believed were below the fair market value of the securities or that submitted "throw-away" bids to broker's brokers would violate Rule G-13. The proposed interpretive notice provides that, while bidders are entitled to make a profit, Rule G-13 does not permit them to do so by "picking off" other dealers at off-market prices.

## Submitting Comments

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You may submit comments on the proposed rules and interpretive notice any time within 21 days following their publication in the Federal Register (1) using the SEC's internet comment form at <http://www.sec.gov/rules/sro.shtml>; (2) by e-mail to [rules-comments@sec.gov](mailto:rules-comments@sec.gov) with "File Number SR-MSRB-2012-04" included in the subject line of the e-mail; or (3) by regular mail to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number SR-MSRB-2012-04.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at [chapman.com](http://chapman.com).

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