

MSRB Proposes New Suitability Rule

The Municipal Securities Rulemaking Board (the “MSRB”) recently proposed a major revision of MSRB Rule G-19 (Suitability of Recommendations and Transactions). The proposal would harmonize Rule G-19 with the general broker-dealer suitability obligation under Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 2111 which became effective in July 2012. The basic suitability obligation in proposed MSRB Rule G-19 essentially mirrors FINRA Rule 2111 but takes a different approach with respect to institutional investor accounts. A copy of the proposed rule marked against FINRA Rule 2111 is included at the end of this Client Alert.

The MSRB notice containing the rule proposal is available at <http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2013/2013-07.aspx>. For detailed information on the FINRA Rule 2111 suitability obligations, see our Client Alert available at http://www.chapman.com/media/publication/39_media.1223.pdf. That publication includes links to additional publications on the adoption of FINRA Rule 2111, subsequent guidance and commentary on doing business under the new FINRA suitability rule.

Background

Current MSRB Rule G-19 differs significantly from FINRA Rule 2111. MSRB Rule G-19 currently requires brokers, dealers and municipal securities dealers to (1) obtain certain customer account information prior to completing a transaction in municipal securities for a non-institutional customer, (2) make reasonable efforts to obtain certain suitability-oriented information from a customer before recommending a municipal security transaction, and (3) have reasonable grounds for believing that a municipal security recommendation is suitable. The new rule would eliminate the first component above and would generally harmonize the other two components with FINRA Rule 2111. Current MSRB Rule G-19 also includes a special suitability provision for discretionary accounts and a provision specifically addressing churning. The new rule would eliminate these provisions and attempt to address these components in a different manner.

Elimination of Obligation to Obtain Account Information

The proposed revisions would eliminate the obligation contained in current MSRB Rule G-19(a) to obtain certain

customer account information prior to completing a transaction in municipal securities for a non-institutional customer and would make corresponding changes to MSRB Rule G-8 in order to streamline the suitability obligations and align them more closely with FINRA Rule 2111. This change is not likely to be overly meaningful because MSRB Rule G-8 will still require maintenance of the same account information and much of the information is basic information needed to service any customer.

Basic Suitability Obligation

New Rule G-19 would essentially replicate the basic suitability obligation contained in FINRA Rule 2111. The proposed rule would require that a broker, dealer or municipal securities dealer have a reasonable basis to believe that a recommended transaction or investment strategy involving a municipal security is suitable for the customer, based on the information obtained through the reasonable diligence of the broker, dealer or municipal securities dealer to ascertain the customer’s investment profile. The new rule would provide that a customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk

tolerance, and any other information the customer may disclose to the broker, dealer or municipal securities dealer in connection with such recommendation.

Similar to FINRA Rule 2111, the proposed suitability obligation would include the three key obligations of (1) reasonable-basis suitability, (2) customer-specific suitability and (3) quantitative suitability. These proposed obligations generally match the related obligations under FINRA Rule 2111, except that the proposed MSRB “reasonable-basis” suitability obligation would also require dealers to have an understanding of information about the municipal security or strategy, including the information described in proposed MSRB Rule G-47 (Time of Trade Disclosure). For information on these obligations under the FINRA rule, please see our Client Alert available at <http://www.chapman.com/media/news/media.1177.pdf>.

Similar to FINRA Rule 2111, proposed Rule G-19 would apply the suitability obligation to “investment strategies”, which would incorporate an explicit recommendation to hold a municipal security, among other things. Proposed supplementary material would define “investment strategy” in a manner similar to FINRA Rule 2111 with slight modifications to focus on municipal securities. Similar to FINRA Rule 2111, the proposed MSRB Rule G-19 would exclude communications of certain educational material so long as any such communication contains no recommendation of a particular municipal security or securities.

Finally, proposed MSRB Rule G-19 would retain the substance of the current prohibition on churning, but would recast such prohibition using the new terminology of “quantitative suitability” from FINRA Rule 2111.

Current Interpretive Guidance

The MSRB has issued guidance on various issues related to current Rule G-19. While some of these issues are incorporated into the proposed new rule, most of the existing Rule G-17 guidance is incorporated into revised Rule G-19 and guidance under that rule. The MSRB has also issued guidance under Rules G-15, G-21, and G-32 that nominally reference suitability obligations and proposes that this guidance would remain intact.

Institutional Accounts

New Rule G-19 would not include the language on institutional investor accounts that is included in FINRA Rule 2111(b). Instead, the MSRB intends to apply existing guidance under MSRB Rule G-17 (essentially a “fair dealing” rule). The MSRB intent appears to be to provide a

similar result as FINRA Rule 211(b) without incorporating a provision into MSRB Rule G-19 itself. The existing guidance under Rule G-17 provides that where a dealer has reasonable grounds for concluding that an institutional customer is a “sophisticated municipal market professional”, then the dealer’s obligation to determine that a recommendation is suitable for that particular customer is fulfilled. This interpretation deals only with guidance regarding how a dealer will fulfill “customer-specific suitability obligations” under Rule G-19 and does not address the suitability obligation to have a “reasonable basis” to believe that the recommendation could be suitable for at least some customers. A “sophisticated municipal market professional” or “SMMP” is an institutional customer of a dealer that: (1) the dealer has a reasonable basis to believe is capable of evaluating investment risks and market value independently, both in general and with regard to particular transactions in municipal securities, and (2) affirmatively indicates that it is exercising independent judgment in evaluating the recommendations of the dealer.

Discretionary Accounts

The current MSRB suitability rule includes a provision on discretionary accounts. The new rule would not include such a provision because the MSRB believes this issue is more appropriately set forth in a separate rule. FINRA’s suitability rule does not include a provision on discretionary accounts. The MSRB proposes to take a similar approach and address discretionary accounts in a separate rule.

Submitting Comments

You may submit comments on the proposed rule changes by submitting a hard copy or by submitting comments electronically at <http://www.msrb.org/Comment.aspx?notice=2013-07>. You may submit comments on the proposed rule until May 6, 2013.

2111-Rule G-19: Suitability of Recommendations and Transactions

~~(a) A member or an associated person~~ A broker, dealer or municipal securities dealer must have a reasonable basis to believe that a recommended transaction or investment strategy involving a municipal security or municipal securities is suitable for the customer, based on the information obtained through the reasonable diligence of the ~~member or associated person~~ broker, dealer or municipal securities dealer to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the ~~member or associated person~~ broker, dealer or municipal securities dealer in connection with such recommendation.

~~(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment advisor or a bank trust department, these factors shall be applied to the agent.~~ ••

Supplementary Material:

.01 General Principles. Implicit in all ~~member and associated person~~ broker, dealer and municipal securities dealer relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of ~~FINRA~~ the MSRB's rules, with particular emphasis on the requirement to deal fairly with ~~the public~~ all persons. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

.02 Disclaimers. A ~~member or associated person~~ broker, dealer or municipal securities dealer cannot disclaim any responsibilities under the suitability rule.

.03 Recommended Strategies. The phrase "investment strategy involving a municipal security or municipal securities" used in this ~~Rule~~ rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a municipal security or municipal securities. However, the following communications are excluded from the coverage of Rule ~~2111~~ G-19 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular municipal security or municipal securities: ~~(a) General~~ general financial and investment information, including (i) basic investment concepts, such as risk and return; ~~and diversification, dollar cost averaging, compounded return, and tax deferred investment,~~ (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, ~~and~~ (v) assessment of a customer's investment profile; ~~and~~ (vi) general comparisons between tax-exempt and taxable bonds and the concept of tax-equivalent yield.

~~(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;~~

~~(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by Rule 2214; and~~

~~(d) Interactive investment materials that incorporate the above.~~

.04 Customer's Investment Profile. A ~~member or associated person~~ broker, dealer or municipal securities dealer shall make a recommendation covered by this ~~Rule~~ rule only if, among other things, the ~~member or associated person~~ broker, dealer or municipal securities dealer has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule ~~2111~~ (a)G-19 regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A ~~member or associated person~~ A broker, dealer or municipal securities

[dealer](#) shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule [2111\(a\)-G-19](#) unless the ~~member or associated person~~[broker, dealer or municipal securities dealer](#) has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

.05 Components of Suitability Obligations. Rule [2111-G-19](#) is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a ~~member or associated person~~[broker, dealer or municipal securities dealer](#) to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least *some* investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the [municipal](#) security or investment strategy and the ~~member's or associated person's~~[broker, dealer or municipal securities dealer's](#) familiarity with the [municipal](#) security or investment strategy. A ~~member's or associated person's~~[broker, dealer or municipal securities dealer's](#) reasonable diligence must provide the ~~member or associated person~~[broker, dealer or municipal securities dealer](#) with an understanding of the potential risks and rewards associated with the recommended [municipal](#) security or strategy, and an understanding of information about the municipal security or strategy, including the information described in [proposed] MSRB Rule G-47 (Time of Trade Disclosure), to the extent such information is material. The lack of such an understanding when recommending a [municipal](#) security or strategy violates the suitability rule.

(b) The customer-specific obligation requires that a ~~member or associated person~~[broker, dealer or municipal securities dealer](#) have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule [2111\(a\)-G-19](#).

(c) Quantitative suitability requires a ~~member or associated person~~[broker, dealer or municipal securities dealer](#) who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule [2111\(a\)-G-19](#). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio,

and the use of in-and-out trading in a customer's account may provide a basis for a finding that a ~~member or associated person~~[broker, dealer or municipal securities dealer](#) has violated the quantitative suitability obligation.

.06 Customer's Financial Ability. Rule [2111-G-19](#) prohibits a ~~member or associated person~~[broker, dealer or municipal securities dealer](#) from recommending a transaction or investment strategy involving a [municipal](#) security or [municipal](#) securities or the continuing purchase of a [municipal](#) security or [municipal](#) securities or use of an investment strategy involving a [municipal](#) security or [municipal](#) securities unless the ~~member or associated person~~[broker, dealer or municipal securities dealer](#) has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

~~**.07 Institutional Investor Exemption.** Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset class-by-asset class basis, or in terms of all potential transactions for its account.~~

For more information please contact any attorney in our Investment Management Group or visit us online at [chapman.com](#).

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