

Client Alert

Current Issues Relevant to Our Clients

March 17, 2014

New MSRB Suitability and Time of Trade Disclosure Rules Effective July 9, 2014

The Securities and Exchange Commission recently approved the Municipal Securities Rulemaking Board's (the "MSRB") rule proposals that focus on fair dealing obligations of dealers in municipal securities. The new rules are effective on July 9, 2014 and include:

- *MSRB Rule G-47—Time of trade disclosure obligations;*
- *MSRB Rule G-19—Suitability obligation for recommended transactions or investment strategies;*
- *MSRB Rule D-15—Defines "Sophisticated Municipal Market Professional" ("SMMP"); and*
- *MSRB G-48—Modifies certain dealer obligations to SMMPs, including "customer-specific" suitability obligation.*

The new suitability rule essentially mirrors FINRA Rule 2111. A comparison of the MSRB rule and the FINRA rule appears at the end of this Client Alert. The MSRB notice, which includes the text of the new rules, is available [here](#).

Time of Trade Disclosure

New MSRB Rule G-47 requires that brokers, dealers, municipal securities dealers (collectively, "dealers") disclose to customers all "material information" known about a municipal security purchase or sale transaction as well as "material information" about the security that is "reasonably accessible to the market". The new rule generally consolidates existing MSRB interpretive guidance and is not intended to substantively change current obligations. The disclosure obligation applies to primary and secondary market transactions and applies to both solicited and unsolicited transactions. The disclosure can be made orally or in writing.

Rule G-47 provides that information is considered "material information" if there is a substantial likelihood that the information would be considered important or significant by a reasonable investor in making an investment decision. The rule defines information that is "reasonably accessible to the market" as information that is made available publicly through "established industry sources", including the MSRB's Electronic Municipal Market Access system, rating agency reports, and other sources generally used by dealers that effect transactions in the type of municipal securities at issue. Supplementary material to the rule provides general information regarding the manner and scope of required disclosure, notes that

dealers operating electronic trading systems have the same disclosure obligations, provides examples describing information that may be material in specific situations, and notes that dealers are required to implement processes and procedures reasonably designed to ensure that material information is disseminated to applicable registered representatives.

Suitability

New MSRB Rule G-19 more closely harmonizes the existing MSRB suitability obligations with FINRA Rule 2111. The basic suitability obligation in MSRB Rule G-19 mirrors FINRA Rule 2111 but takes a slightly different approach with respect to institutional investor accounts. New Rule G-19 requires that a 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 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 dealer in connection with such recommendation.

As is the case with the FINRA rule, the MSRB suitability obligation consists of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability. The FINRA suitability rule includes a specific provision that states that a broker-dealer fulfills the customer-specific suitability obligation for an “institutional account” if (1) it 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 recommendations. New MSRB Rule G-19 does not include this provision but effectively incorporates the same concepts in new MSRB Rules D-15 and G-48, described in the next section of this Client Alert. A marked comparison of the relevant provisions of the new MSRB rules and the comparable FINRA rules appears at the end of this Client Alert.

Sophisticated Municipal Market Professionals (SMMPs)

MSRB Rules D-15 and G-48 on SMMPs generally codify existing guidance regarding the application of MSRB rules to transactions with SMMPs. Rule D-15 defines the term “SMMP”. The SMMP definition includes the same persons covered in FINRA Rule 4512(c) that defines “Institutional Account”. These persons include banks, savings and loan associations, insurance companies, registered investment companies, registered investment advisers and any natural person or entity with total assets of at least \$50 million. A marked comparison of the two rule definitions appears at the end of this Client Alert.

Rule G-48 describes dealer obligations applicable to SMMPs and is not intended to substantively change obligations under existing MSRB guidance. Rule G-48 provides that a dealer’s obligations to a customer that it reasonably concludes is an SMMP are modified as follows:

- Dealers do not have any obligation under MSRB Rule G-47 to disclose time-of-trade information that is “reasonably accessible to the market”;

- Dealers are not obligated under MSRB Rule G-18 to take action to ensure that transactions are effected at fair and reasonable prices as long as the transactions are non-recommended secondary market agency transactions where (1) the dealer’s services have been explicitly limited to providing anonymity, communication, order matching, and/or clearance functions and (2) the dealer does not exercise discretion as to how or when the transactions are executed.;
- Dealers do not have any obligation under MSRB Rule G-19 to perform a “customer-specific” suitability analysis; and
- Dealers disseminating an SMMP’s quotation generally treat an SMMP’s quotation in the same manner as quotations made by another dealer for purposes of the MSRB Rule G-13 bona fide quotation obligation.

What Should I Do Now?

Dealers should consider reviewing their compliance policies and procedures to ensure that they remain consistent with the new rules when they become effective on July 9, 2014. The MSRB generally does not intend the new rules to result in substantive changes in existing dealer obligations and the new suitability rule generally aligns with the existing FINRA suitability rule. As a result, compliance policy updates might not be particularly burdensome but dealers should still update policies reflect the new rules. If you need assistance or have questions, please contact anyone in our Investment Management group.

For More Information

To discuss any topic covered here, please contact any member of the Investment Management Group or visit us at chapman.com

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COMPARISON OF SUITABILITY OBLIGATIONS
MSRB RULE G-19 AND FINRA RULE 2111

~~FINRA~~MSRB Rule ~~2111~~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 decision making authority to an agent, such as an investment adviser 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~~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~~broker, dealer or municipal securities dealer's familiarity with the municipal security or investment strategy. A ~~member's or associated person~~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 ~~security or strategy~~municipal security or strategy and an understanding of information about the municipal

security or strategy, including the information described in 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.~~

MSRB “SMMP” COMPARED TO FINRA “INSTITUTIONAL ACCOUNT”

~~FINRA Rule 4512(c) — “Institutional Account”~~ MSRB Rule D-15 — Sophisticated Municipal Market Professional Definition

~~(c) For purposes of this Rule, the term "institutional account" shall mean the account of:~~ The term “sophisticated municipal market professional” or “SMMP” shall mean a customer of a broker, dealer or municipal securities dealer that is:

- ~~(1) a bank, savings and loan association, insurance company, or registered investment company;~~ or
- ~~(2) an investment adviser registered either with the SEC Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or~~
- ~~(3) any other person entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million; and,~~

~~that the broker, dealer or municipal securities 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 and investment strategies in municipal securities, and that affirmatively indicates that it is exercising independent judgment in evaluating the recommendations of the broker, dealer or municipal securities dealer.~~

MSRB AND FINRA INSTITUTIONAL CUSTOMER-SPECIFIC SUITABILITY

~~FINRA Rule 211G-48(c) — “Institutional Account”~~ SMMP Customer-Specific Suitability

~~(b) A member or associated person fulfills the~~

~~A broker, dealer, or municipal securities dealer’s obligations to a customer that it reasonably concludes is a Sophisticated Municipal Market Professional, or SMMP, shall be modified as follows:~~

~~(c) Suitability. The broker, dealer, or municipal securities dealer shall not have any obligation under Rule G-19 to perform a 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 decision-making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent analysis.~~