Chapman and Cutler LLP

Chapman Client Alert

March 2, 2016 Current Issues Relevant to Our Clients

MSRB Publishes its First Compliance Advisory for Broker-Dealers

The Municipal Securities Rulemaking Board (*"MSRB"*) recently published its 2016 Compliance Advisory for Brokers, Dealers and Municipal Securities Dealers. The Compliance Advisory outlines several MSRB rules that the MSRB believes present key compliance risks for brokers, dealers and municipal securities dealers (*"dealers"*). In order to mitigate exposure to those compliance risks, the Compliance Advisory provides dealers with non-exhaustive lists of factors to consider when evaluating compliance procedures and controls. The MSRB intends for dealers to use the advisory as a tool to supplement their evaluations of the adequacy of their compliance programs. Note that the Compliance Advisory specifically addresses dealers but does not discuss municipal advisors that are not acting as dealers. The MSRB also intends for the Compliance Advisory to assist the Securities and Exchange Commission ("*SEC*") and Financial Industry Regulatory Authority, Inc. ("*FINRA*") in the development of regulatory examination programs for dealers conducted by the SEC and FINRA. You can obtain a copy of the Compliance Advisory here. The SEC and FINRA have separately published their annual examination priorities. For information on those publications, please see our related Client Alerts available here and here.

Compliance Risks

The Compliance Advisory highlights the compliance risks described below. Please feel free to contact us to discuss factors that the MSRB suggests dealers consider when evaluating compliance with these rules.

Fair Pricing Standards and Best Execution (Rules G-30 and G-18): A dealer must purchase from or sell to a customer at an aggregate price (including any mark-up or mark-down) that is fair and reasonable if acting as principal, and at fair and reasonable commissions if acting as agent. Under new MSRB Rule G-18 (Best Execution), dealers will also be required to use reasonable diligence to ascertain the best market for a municipal security in any transaction for or with a customer and buy or sell in that market so that the price to the customer is as favorable as possible under prevailing market conditions. For an overview on the new best execution rule that becomes effective March 21, 2016, please see our December 1, 2015 Client Alert available here.

Suitability (Rule G-19): One of the three components of the suitability obligation is that a dealer must have a reasonable basis to believe, based on reasonable diligence, that a recommendation involving a municipal security is suitable for at least some investors. This "reasonable basis suitability" determination requires that a dealer understand the material information regarding the security or strategy and the potential risks and benefits associated with the recommendation. Dealers also have a customer-specific obligation to have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. The Compliance Advisory notes that dealers should be particularly careful regarding new types of municipal products and existing products that are complex or risky such that they are inherently unsuitable for most retail investors. The MSRB points out that dealers could violate the suitability obligation my failing to understand any minimum denomination of bonds authorized for trading in offering documents or other restrictions on resales to qualified investors.

Time of Trade Disclosure (Rule G-47): Dealers are prohibited from selling to or purchasing from a customer without disclosing all material information known about the transaction and the material information about the security that is reasonably accessible to the market. A dealer must make this disclosure at or prior to the time of trade either orally or in writing and should be able to document that the disclosure was made. The disclosure requirement applies to all transactions regardless of whether the transaction is solicited or unsolicited but does not apply to transactions with "sophisticated municipal market professionals" if the dealer obtains required affirmations.

Pay-to-Play Restrictions (Rule G-37): Dealers may not seek municipal securities business from municipal issuers if a prohibited political contribution has been made. Contributions include anything of value used to influence an issuer official and the limits apply to political action committees, or PACs, controlled by a dealer or one of its municipal finance professionals. Dealers should consider relevant training and monitoring of their personnel.

Fair Dealing (Rule G-17): Dealers must deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice with respect to municipal securities activities. This obligation applies to activities with investors and all other market participants. For example, the MSRB highlights that a dealer engaged in a negotiated underwriting must disclose conflicts of interest to the bond issuer, among other things regarding the underwriter's role and duties.

Prohibitions on Underwriting Activities when Engaged in Financial Advisory Activities (Rule G-23): A dealer with a financial advisory relationship with a municipal entity with respect to the issuance of municipal securities may not directly or indirectly acquire any portion of the bond issue from the issuer as principal, or acting as agent for the issuer in arranging placement of the bonds. The MSRB notes that a dealer that clearly identifies itself as an underwriter and not as a financial advisor will generally be considered to be acting as an underwriter. However, notwithstanding any self-identification as an underwriter by a dealer, the MSRB will deem a dealer to be a financial advisor precluded from acting as an underwriter if the dealer engages in a course of conduct that is inconsistent with an arms-length relationship with the municipal entity in connection with an issue.

Gifts, Gratuities and Non-Cash Compensation (Rule G-20): Among other things, a dealer is prohibited from giving, directly or indirectly, any service or thing of value in excess of $100 per person per year in relation to the municipal securities activities of the recipient's employer, with certain exceptions. Revisions to MSRB Rule G-20 become effective on May 6, 2016. For an overview of the revised rule, please see our November 20, 2015 Client Alert available here.

Supervisory Procedures (Rule G-27): Dealers must supervise the conduct of their municipal securities activities and establish a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB rules. The MSRB believes that a reasonably designed supervisory system would address when the dealer is effecting any transaction in, or inducing or attempting to induce the purchase or sale of, a municipal security and that this could include private placements of debt with a single purchaser (including bank or other loans) or a direct purchase of a variable rate demand obligation by a bank followed by a restructuring of the terms of the obligation. The MSRB also notes that engaging unqualified outside service providers to deliver core compliance functions, such as recordkeeping and trade reporting, or failing to manage the relationship vigorously, can create compliance failures, including those related to system vulnerabilities and possible cybersecurity threats.

Professional Qualification Standards and Municipal Advisor Registration of Dealers (Rules G-2 and G-3): Dealers, municipal advisors and their associated persons must be qualified in accordance with MSRB rules to conduct municipal securities or advisory activities. The MSRB reminds dealers to monitor their activity to ensure that appropriate registrations are in place prior to engaging in a new activity, such as acting as a municipal advisor.

What To Do Now

By highlighting some key compliance risks and providing considerations tailored to those risks, the Compliance Advisory attempts to aid dealers in developing and assessing effective compliance programs. Dealers should consider reviewing their firm's existing compliance policies and procedures in light of the considerations discussed in the Compliance Advisory.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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