

SEC Approves New MSRB Broker's Brokers Rule

The Securities and Exchange Commission ("SEC") recently approved the Municipal Securities Rulemaking Board ("MSRB") rule proposals governing the conduct of broker's brokers. The new rules consist of (a) new MSRB Rule G-43 governing the municipal securities activities of broker's brokers and certain alternative trading systems; (b) amendments to MSRB Rules G-8, G-9, and G-18 concerning recordkeeping, record retention, and agency trades by broker's brokers; and (c) interpretive notice on the duties of dealers that use the services of broker's brokers. The new rule, amendments, and interpretive notice become effective on December 22, 2012. The MSRB notice of the new rule is available at <http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-34.aspx> and the SEC order granting approval of the rule is available at <http://sec.gov/rules/sro/msrb/2012/34-67238.pdf>.

Background

The MSRB originally requested guidance on the application of existing MSRB rules to broker's brokers in September 2010. The request was, in part, a result of enforcement actions by both the SEC and Financial Industry Regulatory Authority involving broker's broker activities constituting violations of MSRB rules. Since then:

- in February 2011, the MSRB issued a rule proposal governing the conduct of broker's brokers (see our March 15, 2011, [Client Alert](#));
- in September 2011, the MSRB issued a revised rule proposal (see our October 5, 2011, [Client Alert](#));
- on March 5, 2012, the MSRB submitted a revised rule proposal to the SEC (see our March 23, 2012, [Client Alert](#));
- on May 3, 2012, the MSRB submitted an amended proposal (in response to comments received after the SEC published the proposed rule for comment); and
- on June 22, 2012, the SEC approved an amended MSRB rule proposal.

What is a Broker's Broker?

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. A broker's broker can be either an individual company or a part of a company. Rule G-43 specifically provides that an alternative trading system registered with the SEC is not a broker's broker for purposes of the rule if it meets certain conditions with respect to its municipal securities activities. Despite requests during the proposal process, the MSRB has given almost no guidance on when a dealer may be deemed to "principally effect transactions for other dealers" or "holds itself out as a broker's broker." However, the MSRB has stated that it is "highly unlikely" for broker-dealers that have historically participated in new issue syndicates and proprietary trading to be considered to be principally effecting transactions for other dealers or to hold themselves out as a broker's broker.

Basic Duties of a Broker's Broker

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 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 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 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 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

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:

- Unless otherwise directed by the seller, the broker's broker makes a reasonable effort to disseminate the bid-wanted widely (including, but not limited to, the

underwriter of the issue and prior known bidders on the issue) 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 either orally or in writing.

Required Policies and Procedures

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 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 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 commission or other economically similar 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 wanteds (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.

Amended Record-Keeping Obligations

Amendments to Rules G-8 and G-9 require each broker's broker to keep certain records with respect to municipal securities activities.

Interpretive Notice for Firms Using Broker's Brokers

In addition to the foregoing rule changes, the MSRB is providing an interpretive notice concerning the obligations of brokers, dealers, and municipal securities dealers that use the services of a broker's broker. The 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 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 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 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 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 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 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.

Effective Date

The new rule, amendments and interpretive notice will become effective on December 22, 2012.

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.

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