



MSRB NOTICE 2011-60 (OCTOBER 13, 2011)

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## MSRB FILES WITH THE SEC AMENDMENTS TO RULE G-16 TO FACILITATE RISK-BASED COMPLIANCE EXAMINATIONS AND AMENDMENTS TO RULE G-9, ON PRESERVATION OF RECORDS

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Today, the MSRB filed with the Securities and Exchange Commission (“SEC”) a proposed rule change consisting of amendments to Rule G-16, on periodic compliance examination, and Rule G-9, on preservation of records, in order to facilitate the establishment of a risk-based compliance examination program for brokers, dealers, and municipal securities dealers (“dealers”) that are members of the Financial Industry Regulatory Authority (“FINRA”).<sup>[1]</sup>

The purpose of the proposed rule change is to facilitate the modernization of the examination process for dealers and to permit greater flexibility in the administration of periodic compliance examinations in order to focus more closely on those dealers that, by virtue of various identified factors, pose the greatest risk to investors and other market participants, as well as to the municipal securities market on a systemic basis.

Periodic examinations of regulated entities are an important component of the regulatory oversight process. Examinations are intended to detect wrongful conduct, including violations of the federal securities laws and self-regulatory organization rules. Pursuant to Section 15B(b)(2)(E) of the Securities Exchange Act of 1934 (the “Exchange Act”), MSRB rules must provide for the periodic examination of municipal securities brokers, municipal securities dealers, or municipal advisors (“regulated entities”) to determine compliance with Section 15B of the Exchange Act, the rules and regulations thereunder, and MSRB rules. The same provision requires that the MSRB specify the minimum scope and frequency of the examinations and that the examination rules be designed to avoid unnecessary regulatory duplication or undue regulatory burden for any regulated entity.

Section 15B(c)(7) of the Exchange Act provides that the periodic examination of regulated entities shall be conducted by (a) a registered securities association in the case of dealers that are members of the registered securities association, (b) the appropriate regulatory agency (“bank regulators”) in the case of dealers that are not members of a registered securities association, and (c) the SEC, or its designee, in the case of municipal advisors. There is one securities association registered with the SEC – FINRA. Approximately 1,800 MSRB registered dealers are members of and examined by FINRA, with the remaining dealers registered with the SEC as municipal securities dealers and examined primarily by the various federal bank regulators.

Rule G-16 currently provides that, at least once every two calendar years, dealers must be examined in accordance with Section 15B of the Exchange Act, in order to determine whether the dealers are in compliance with all MSRB rules and applicable provisions of the Exchange Act. Separately, FINRA examines its members pursuant to a risk-based approach at least every four calendar years. In order to comply with Rule G-16, FINRA and the MSRB agreed to a protocol allowing for a questionnaire to be completed by certain firms every two calendar years. These dealers are typically less active in the municipal securities market and, therefore, pose less overall risk to market participants. The questionnaire, entitled the Alternative Municipal Examination (“AME”) module, was implemented in 1998, after review by SEC and MSRB staff.

The AME is used as an off-site examination for low-risk dealers that: (a) conduct a limited municipal securities business; (b) do not conduct a public finance business; and (c) are not otherwise identified as high risk firms for regulatory purposes. The AME is necessarily general and not tailored to the specific business of any one firm. It relies on each responding dealer to self report rule violations and to certify that the information provided is truthful and accurate.

After many years of experience with the AME, the MSRB and FINRA believe that a more risk-based examination protocol should be implemented and that Rule G-16 should be amended to allow for up to a four year examination cycle for FINRA-member firms, consistent with FINRA's requirement for cycle examinations of all other FINRA members. This would also allow FINRA to integrate the municipal securities cycle examination program more closely with its overall cycle examination program, and redeploying staff resources from administering the AME to participating in the risk-based examination program would foster more meaningful oversight. Moreover, over the last few years, there have been significant advances in information technology, particularly with the development of the MSRB's Real-time Transaction Reporting System and Electronic Municipal Market Access system. These advancements in information technology and transparency have enabled FINRA to develop robust automated surveillance reviews of municipal securities transactions. FINRA is now able to review municipal securities transactions and other activity remotely, in order to identify potential MSRB rule violations by dealers. These tools permit FINRA staff to conduct near real-time surveillance of certain municipal securities activities.

It is also apparent that the municipal securities business has changed dramatically over the last few years. The industry has consolidated and a small number of large firms account for the majority of public finance business. The top five underwriters accounted for over 50 percent, by par amount, of primary offerings in 2010 and 2011<sup>[2]</sup>. The top 10 underwriters accounted for over 70 percent of the underwritings, by par amount, in 2010 and 2011, and the top 200 accounted for almost 100 percent of the underwritings, by par amount, in 2010 and 2011. According to data gathered by the MSRB, the top 10 dealers executed approximately 55 percent of all municipal securities transactions reported to the MSRB in 2010 and 2011. The top 50 dealers executed approximately 80 percent of all such transactions in 2010 and 2011, and the top 200 dealers executed approximately 96 percent of all such transactions. By par amount, the top 200 dealers executed approximately 98 percent of all municipal securities transactions reported to the MSRB in 2010 and 2011. The remaining approximately 1,600 firms are less active in the municipal securities market, engage solely in the sale of interests in 529 College Savings Plans, or effect municipal securities transactions primarily as an accommodation to their customers. Generally, these firms are not engaged in financial advisory activities or municipal securities underwriting, research, or trading. They, therefore, do not pose systemic risk to the market in these areas.

With input from the MSRB, consistent with Section 15B(b)(4) of the Exchange Act, FINRA is enhancing its risk assessment approach to rank dealers by certain risk factors, as well as by size and scope of business, to determine their examination cycle frequencies, which under the proposed rule change would range from one to four years, rather than every two years as currently prescribed by Rule G-16. It is anticipated that, based on the analysis of the various identified risks and related factors, those firms that represent higher risks, as well as firms that pose a systemic threat based on the scope and scale of their underlying municipal securities activities, would be examined on an annual basis. Other firms would be examined less frequently, every two to four years, depending on the risk ranking and size of their municipal securities business and the firm's overall business model. At a minimum, all firms would be examined at least once every four calendar years. Cycle examination frequencies for dealers would be re-assessed at least on an annual basis. FINRA would continue to conduct off-site surveillance of municipal securities activity and "cause" examinations as needed. "Cause" examinations are event-driven and typically initiated as a result of customer complaints, regulatory tips, and other information sources identified by FINRA via its regulatory oversight process.

The MSRB believes that using quantitative and qualitative criteria to rank dealers by appropriately identified risk measures and size no less frequently than on an annual basis provides better protection for investors, municipal entities, and other market participants, since FINRA's resources will be focused on those firms that pose the greatest risk to investors, municipal entities and the market. Such firms will be subject to in-depth examinations tailored to the specific municipal securities activities they conduct.

Finally, the MSRB has proposed a rule change requiring dealers that are FINRA members to retain certain records for four years, rather than for three years, under Rule G-9 in order to ensure that the records are available at those firms that are examined every four calendar years.

Questions about the rule amendments should be directed to Lawrence P. Sandor, Senior Associate General Counsel at (703) 797-6600.

## TEXT OF PROPOSED AMENDMENTS [3]

### Rule G-16: Periodic Compliance Examination

At least once each two four calendar years, each broker, dealer and municipal securities dealer that is a member of a registered securities association, and at least once each two calendar years, each municipal securities dealer that is a bank or subsidiary or department or division of a bank, shall be examined in accordance with Section 15B(c)(7) of the Act to determine, at a minimum, whether such broker, dealer or municipal securities dealer and its associated persons are in compliance with all applicable rules of the Board and all applicable provisions of the Act and rules and regulations of the Commission thereunder.

### Rule G-9: Preservation of Records

(a) No change.

(b) *Records to be Preserved for ~~Three~~ **Four** Years.* Every broker, dealer and municipal securities dealer shall preserve the following records for a period of not less than three four years; provided, however, that each municipal securities dealer that is a bank or subsidiary or department or division of a bank shall preserve the following records for a period of not less than three years:

(i) - (xvii) No change.

(c) – (f) No change.

(g) *Compliance with Rules 17a-3 and 17a-4.* Brokers, dealers and municipal securities dealers other than bank dealers that which are in compliance with rules 17a-3 and 17a-4 under the Act will be deemed to be in compliance with the requirements of this rule, provided that the records enumerated in section (f) of ~~Rule G-8~~ of the Board and section (b) of this rule shall in any event be preserved for the applicable time periods specified in this rule.

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[1] File No. SR-MSRB-2011-19. Comments on the proposed rule change should be submitted to the SEC and should reference this file number.

[2] All 2011 figures are through September 2011. Underwriting statistics are provided by Thomson Reuters.

[3] Underlining indicates additions; strikethrough denotes deletions.