



MSRB NOTICE 2008-04 (JANUARY 22, 2008)

BOND INSURANCE RATINGS – APPLICATION OF MSRB RULES

Bond insurance companies recently have been subject to increased attention in the municipal securities market as a result of credit rating agency downgrades and ongoing credit agency reviews. Because of these recent events and the prominence of bond insurance in the municipal securities market, the MSRB is publishing this notice to review some of the investor protection rules applicable to brokers, dealers and municipal securities dealers (“dealers”) effecting transactions in insured municipal securities.

RULE G-17 AND TIME OF TRADE DISCLOSURE TO CUSTOMERS

One of the most important MSRB investor protection rules is Rule G-17, which requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. A longstanding interpretation of Rule G-17 is that a dealer transacting with a customer^[1] must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security.^[2] Disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered “material” if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.^[3] As applied to customer transactions in insured municipal securities, the disclosures required under Rule G-17 include a description of the securities and identification of any bond insurance as well as material facts that relate to the credit rating of the issue. The disclosures required under Rule G-17 also may include material facts about the credit enhancement applicable to the issue.

March 2002 Notice

In a March 2002 Interpretative Notice, the MSRB provided specific guidance on the disclosure requirements of Rule G-17.^[4] The March 2002 Notice clarified that, in addition to the requirement to disclose material facts about a transaction of which the dealer is specifically aware, the dealer is responsible for disclosing any material fact that has been made available through sources such as the NRMSIR system,^[5] the Municipal Securities Information Library[®] (MSIL[®]) system,^[6] RTRS,^[7] *rating agency reports* and other sources of information relating to the municipal securities transaction generally used by dealers that effect transactions in the type of municipal securities at issue (collectively, “established industry sources”).^[8] The inclusion of “rating agency reports” within the list of “established industry sources” of information makes clear the Board’s view that information about the rating of a bond, or information from the rating agency about potential rating actions with respect to a bond, may be material information about the transaction. It follows that, where the issue’s credit rating is based in whole or in part on bond insurance, the credit rating of the insurance company, or information from the rating agency about potential rating actions with respect to the bond insurance company, may be material information about the transaction.

In addition to the actual credit rating of a municipal issue, “underlying” credit ratings are assigned by rating agencies to some municipal securities issues. An underlying credit rating is assigned to reflect the credit quality of an issue independent of credit enhancements such as bond insurance. The underlying rating (or the lack of an underlying rating)^[9] may be relevant to a transaction when the credit rating of the bond insurer is downgraded or is the subject of information from the rating agency about a potential rating action with respect to the insurance company. In order to ensure all required disclosures are made under Rule G-17, a dealer must take into consideration information on underlying credit ratings that is available in established industry sources (or information otherwise known to the dealer) and must incorporate such information when determining the material facts to be disclosed about the transaction.

April 2002 Notice on Sophisticated Municipal Market Professionals

In a notice dated April 30, 2002, the MSRB provided additional guidance on Rule G-17 and other customer protection rules as they apply to transactions with a special class of institutional customers known as “Sophisticated Municipal Market Professionals” (“SMMPs”). [10] The April 2002 Notice provides a definition of SMMP, which includes critical elements such as the customer’s financial sophistication and access to established industry sources for municipal securities information. When a dealer has reasonable grounds for concluding that the institutional customer is an SMMP as defined in the April 2002 Notice, the institutional customer necessarily is already aware, or capable of making itself aware of, material facts found in the established industry sources. In addition, the customer in such cases is able to independently understand the significance of such material facts.

The April 2002 Notice provides that a dealer’s Rule G-17 obligation to affirmatively disclose material facts available from established industry sources is qualified to some extent in certain kinds of SMMP transactions. Specifically, when effecting non-recommended, secondary market transactions, a dealer is not required to provide an SMMP with affirmative disclosure of the material facts that already exist in established industry sources. This differs from the general Rule G-17 requirement of disclosure, discussed above, and therefore may be relevant to dealers trading with SMMPs in insured municipal securities.

RULE G-19 AND SUITABILITY DETERMINATIONS

In addition to the customer disclosure obligations relating to bond insurance and credit ratings, dealers also should be aware of how suitability requirements of MSRB Rule G-19 relate to transactions in insured bonds that are recommended to customers. Rule G-19 provides that a dealer must consider the nature of the security as well as the customer’s financial status, tax status and investment objectives when making recommendations to customers. The dealer must have reasonable grounds for believing that the recommendation is suitable, based upon information available about the security and the facts disclosed by or otherwise known about the customer. [11] Facts relating to the credit rating of a bond insurer may affect suitability determinations, particularly for customers that have conveyed to the dealer investment objectives relating to credit quality of investments. For example, if a customer has expressed the desire to purchase only “triple A” rated securities, recommendations to the customer should take into account information from rating agencies, including information about potential rating actions that may affect the future “triple A” status of the issue. [12]

RULE G-30 AND FAIR PRICING REQUIREMENTS

Another important investor protection provision within MSRB rules is Rule G-30 on prices and commissions. Rule G-30 requires that, for principal transactions with customers, the dealer must ensure that the price of each transaction is fair and reasonable, taking into account all relevant factors. Dealers should consider the effect of ratings on the value of the securities involved in customer transactions, and should specifically consider the effect of information from rating agencies, both with respect to actual or potential changes in the underlying rating of a security and with respect to actual or potential changes in the rating of any bond insurance applicable to the security.

RULE G-15(a) AND CONFIRMATION DISCLOSURE

The content of information required to be included on customer confirmations of municipal securities transactions is set forth in MSRB Rule G-15(a). For securities with additional credit backing, such as bond insurance, the rule requires the confirmation to state “the name of any company or other person in addition to the issuer obligated, directly or indirectly, with respect to debt service.” [13] Rule G-15(a) does not generally require that credit agency ratings be included on customer confirmations. However, if credit ratings are given on the confirmation, the ratings must be correct.

CONCLUSION

Meeting the disclosure requirements of Rule G-17 requires attention to the facts and circumstances of individual transactions as well as attention to the specific securities and customers that are involved in those transactions. In light of recent events affecting credit ratings of bond insurance companies, dealers may wish to review both the March 2002 Notice on Rule G-17 disclosure requirements and the April 2002 Notice on SMMP transactions to ensure compliance with the rule in the changing environment for bond insurance companies. In

addition, dealers may wish to review how transactions in insured securities are being recommended, priced and confirmed to customers to ensure compliance with other MSRB investor protection rules.

January 22, 2008

[1] The word "customer," as used in this notice, follows the definition in MSRB Rule D-9, which states that a "customer" is any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities.

[2] See, e.g., Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (March 4, 1986), MSRB Manual (CCH) para. 3591.

[3] See, e.g., *Basic v. Levinson*, 485 U.S. 224 (1988).

[4] Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, MSRB Notice (March 25, 2002) (hereinafter "March 2002 Notice").

[5] For purposes of this notice, the "NRMSIR system" refers to the disclosure dissemination system adopted by the SEC in SEC Rule 15c2-12.

[6] The MSIL[®] system collects and makes available to the marketplace official statements and advance refunding documents submitted under MSRB Rule G-36, on the delivery of official statements, as well as certain secondary market material event disclosures provided by issuers under SEC Rule 15c2-12. Municipal Securities Information Library[®] and MSIL[®] are registered trademarks of the MSRB.

[7] The MSRB's Real-Time Transaction Reporting System ("RTRS") collects and makes available to the marketplace information regarding inter-dealer and dealer-customer transactions in municipal securities.

[8] See March 2002 Notice (emphasis added).

[9] The lack of a rating for a municipal issue does not necessarily imply that the credit quality of such an issue is inferior, but is information that should be taken into account when accessing material facts about a transaction in the security.

[10] Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals (April 30, 2002) (hereinafter "April 2002 Notice").

[11] As with Rule G-17, the MSRB has provided specific qualifications with respect to how a dealer fulfills its suitability duties when making recommendations to SMMPs. These are described in the April 2002 Notice on SMMPs, discussed above.

[12] To assure that a dealer effecting a recommended transaction with a non-SMMP customer has the information needed about the customer to make its suitability determination, Rule G-19 requires the dealer to make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation. The obligations arising under Rule G-19 in connection with a recommended transaction require a meaningful analysis, taking into consideration the information obtained about the customer and the security, which establishes the reasonable grounds for believing that the recommendation is suitable. Such suitability determinations should be based on the appropriately weighted factors that are relevant in any particular set of facts and circumstances, which factors may vary from transaction to transaction. See *Reminder of Customer Protection Obligations In Connection With Sales of Municipal Securities*, MSRB Notice 2007-17 (May 30, 2007).

[13] The rule provides that, if there is more than one such obligor, the statement "multiple obligors" may be shown. If a security is unrated by a nationally recognized statistical rating organization, Rule G-15(a) requires dealers to disclose the fact that the security is unrated

