

SECURITIES AND EXCHANGE COMMISSION
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December 13, 2006

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of Proposed Rule Change Relating to Amendments to Rule G-27, on Supervision, Rule G-8, on Recordkeeping, and Rule G-9, on Record Retention

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 24, 2006, the Municipal Securities Rulemaking Board (“MSRB” or “Board”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

The MSRB is filing with the Commission a proposed rule change consisting of amendments to Rule G-27, on supervision, and the related recordkeeping and record retention requirements of Rules G-8 and G-9. The text of the proposed rule change is available on the MSRB’s Web site (<http://www.msrb.org>), at the MSRB’s principal office, and at the Commission’s Public Reference Room.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, the MSRB included statements concerning the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Over the past two years, NASD and the New York Stock Exchange (“NYSE”) have adopted a series of rule changes designed to strengthen the supervisory control procedures of their member firms. Specifically, NASD amended its Rule 3010 (Supervision) to include more stringent office inspection rules, and adopted new Rule 3012 (Supervisory Control System) to require the testing and verification of a firm’s supervisory procedures.³

MSRB Rule G-27, on supervision, requires brokers, dealers and municipal securities dealers (collectively referred to as “dealers”) to supervise their municipal securities activities by designating individuals with supervisory responsibilities for municipal securities activities, adopting written supervisory procedures, and reviewing transactions and correspondence. Similarly, NASD Rule 3010 requires dealers to establish a supervisory system, adopt written supervisory procedures, review transactions and correspondence, and, most recently, to conduct internal inspections with minimum inspection cycles. NASD also recently adopted new Rule 3012 to require that dealers: (1) test and verify that its supervisory procedures are sufficient, and amend or create additional

³ The NASD and NYSE amendments are substantially similar.

supervisory procedures where the testing and verification identify a need; and (2) establish procedures that are reasonably designed to review and supervise, on a day-to-day basis, the customer account activity conducted by the dealer's producing managers.

In April 2006, the MSRB published for comment draft amendments to Rule G-27, which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically applicable to the municipal securities activities of securities firms and bank dealers.⁴ The Board received two comment letters in response to the notice, both of which expressed support for the draft amendments, as more fully described below.⁵ Based on the comment letters received, as well as discussions with various industry participants and the relevant regulatory agencies, the Board determined to adopt the draft amendments with one substantive revision relating to the designation of appropriate principal. Although the new supervisory activities required under the proposed rule change are derived from NASD requirements, these activities relate specifically to a dealer's municipal securities activities and require in-depth knowledge of MSRB rules. Therefore, the Board believes it is appropriate that these supervisory activities be undertaken by a

⁴ MSRB Notice 2006-11 (April 21, 2006).

⁵ Although the notice specifically requested comment from bank dealers, particularly on their ability to comply with the new requirements relating to tape recording of conversations, office inspection, and the new supervisory control provisions, the Board did not receive comment letters from bank dealers. Based on the absence of comment letters from this segment of the industry, as well as informal discussions with the bank regulatory agencies, the Board has no reason to believe that bank dealers will be unable to comply with the new requirements for supervision.

municipal securities principal (or a municipal fund securities limited principal in the case of activities related to municipal fund securities). The proposed rule change clarifies these requirements by amending the “Appropriate Principal” provision in Rule G-27(b)(ii)(C).⁶

The MSRB believes that adopting most of the requirements of NASD Rules 3010 and 3012 will help ensure a coordinated regulatory approach in the area of supervision, and will facilitate inspection and enforcement.⁷ The proposed amendments to Rule G-27 are described below.

Description of Proposed Amendments

The proposed amendments modify section (b) of Rule G-27, on supervisory system; add new subsection (c)(ii), on tape recording of conversations; add new subsection (c)(iii) on updating written supervisory procedures; add new section (d), on

⁶ This provision is also amended to make clear that supervision with respect to correspondence under Rule G-27(e) is to be undertaken by a municipal securities principal (or a municipal fund securities limited principal in the case of correspondence relating to municipal fund securities) or a municipal securities sales principal.

⁷ The MSRB notes that NASD Rule 3013 (Annual Certification of Compliance and Supervisory Processes) requires NASD member firms to designate a principal to serve as chief compliance officer and to certify, on an annual basis, that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations. This requirement became fully operative on April 1, 2006. Since all NASD member firms are subject to this rule (which requires that firms have supervisory procedures for compliance with MSRB rules), the Board has not incorporated this requirement into amended Rule G-27. Bank dealers, however, are not currently subject to this requirement since they are not NASD members. Therefore, after the Rule G-27 amendments have been in effect for approximately a year, the Board will seek feedback from the bank regulators concerning bank dealers’ ability to comply with the new supervisory requirements over that time period. Assuming there are no compliance problems or concerns in this area, the Board will then consider the propriety of adopting an annual certification requirement for bank dealers.

internal inspections; add new section (f), on supervisory control system; and add new definitions section (g). As a general principle, the requirements of Rule G-27 apply only with respect to those registered persons who engage in municipal securities activities and those offices in which such municipal securities activities are undertaken (regardless of the level or amount of such municipal securities activities).

Supervisory System

The proposed amendments modify section (b) of Rule G-27, on supervisory system, to include the following five provisions:⁸

- Designation of certain locations as offices of supervisory jurisdiction (“OSJ”) (G-27(b)(iii));
- Designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the dealer (G-27(b)(iv));
- Assignment of each registered person to an appropriately registered representative or principal who shall be responsible for supervising that person’s activities (G-27(b)(v));
- Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities (G-27(b)(vi)); and

⁸ These provisions are based on NASD Rule 3010(a)(3)-(7).

- Participation of each registered representative and principal in an annual meeting to discuss compliance matters (G-27(b)(vii)).

The amendments also include a reference in Rule G-27(b)(ii)(C) to “municipal fund securities limited principal” that is added to explicitly affirm the supervisory functions that such a principal may undertake pursuant to Rule G-3, on professional qualifications. Specifically, paragraph (b)(iv)(C) of Rule G-3 allows a municipal fund securities limited principal to “undertake all actions required or permitted under any Board rule to be taken by a municipal securities principal, but solely with respect to activities related to municipal fund securities.”

Tape Recording of Conversations

The amendments incorporate NASD Rule 3010(b)(2), on tape recording of conversations, in Rule G-27(c)(ii). Subsection (c)(ii) requires dealers to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from certain firms that have been expelled or have had their broker/dealer registrations revoked for violations of sales practice rules. The requisite percentage varies depending on the size of the dealer, from 40 percent for a small dealer to 20 percent for a larger dealer. The dealer must establish the required supervisory procedures within 30 days of receiving notice from their registered securities association or bank regulator, or obtaining actual knowledge that it is subject to this provision of the rule.

Under this provision, if the requisite percentage of a dealer’s sales force previously was employed by a disciplined firm, the dealer will be required to adopt special written procedures to supervise the telemarketing activities of all its registered

persons. The procedures require, at a minimum, that the dealer tape record all telephone conversations between all of its registered persons and both existing and potential customers for a period of two years. The measures required by this provision are designed to prevent a recurrence of sales practice abuse or other customer harm that caused the disciplined firm to have its registration revoked.

This provision also requires dealers subject to the taping requirement to establish reasonable procedures for reviewing tape recordings to ensure compliance with securities laws and applicable rules and regulations, to retain and catalog the tapes, and to submit reports to the appropriate registered securities association or bank regulator on their supervision of telemarketing.

Updating Written Supervisory Procedures

Subsection (c)(iii) is added to replace existing section (e), which currently requires a dealer to revise and update its written supervisory procedures as necessary to respond to changes in Board or other applicable rules. Proposed subsection (c)(iii) has language that mirrors the language in NASD Rule 3010(b)(4), and requires each dealer to keep a copy of procedures at each location where supervisory activities are conducted and to amend its written supervisory procedures within a reasonable time after changes occur.

Internal Inspections

The amendments incorporate NASD Rule 3010(c), on internal inspections, in new section (d) under Rule G-27. This new section imposes office inspection requirements that establish minimum inspection cycles and delineate the topics that must be covered

during such inspections as well as the manner in which inspections are documented.⁹ In addition, the amendments include new section (g) which defines the designations “office of supervisory jurisdiction” and “branch office” used in section (d), among other terms.

Mandatory Inspection Cycles. Section (d) obligates dealers to inspect OSJs and supervisory branch offices on at least an annual basis.¹⁰ It also requires dealers to inspect all non-supervisory branch offices at least once every three years. It directs dealers, however, to consider when it might be appropriate to conduct more frequent inspection of non-supervisory branch offices. Further, Rule G-27(d) requires dealers to inspect non-branch locations “on a regular periodic schedule.” Each dealer must document, as part of its written supervisory procedures, an explanation of how the dealer determined the frequency of its examination schedule. In establishing the schedule, dealers should consider the nature and complexity of the securities activities for which each non-branch location is responsible, and the frequency of customer contact at the non-branch location.

Independent Office Inspections. Section (d) places limits on who is eligible to perform the required inspection function. This provision prohibits office inspections from being performed by:

- the branch office manager;
- any person within the office who has supervisory responsibilities; or

⁹ The stringency of the office inspection requirements is graduated and based on designations of offices under specifically defined categories, such as office of supervisory jurisdiction, supervisory and non-supervisory branch offices, and non-branch offices.

¹⁰ A “branch office” is defined in Rule G-27(g) as “any location where one or more associated persons of a dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding [certain enumerated locations].” A “supervisory branch office” is any non-OSJ branch office that is responsible for supervising one or more non-branch offices.

- any individual who is directly or indirectly supervised by such person(s).

However, an exception to this limitation is provided if the dealer is so limited in size and resources that it cannot comply with it.

Content of Inspections and Requirements for Inspection Reports. Dealers must document each office inspection by preparing a written report that documents when it conducted the inspection and the results of its testing and verification in the following areas:

- Safeguarding customer funds and securities;
- Maintaining books and records;
- Supervising customer accounts services by branch office managers;
- Transmitting funds between customer and registered representative and between customers and third parties;
- Validating customer address changes; and
- Validating changes in customer account information.

Heightened Inspection Requirements. Section (d) also requires dealers to adopt, under certain circumstances, procedures that require heightened inspections designed to avoid conflicts of interest arising from economic, commercial or financial interests that the branch manager's supervisor holds in the person or activities being inspected. Such heightened inspection procedures are required if (1) the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor; and (2) the branch office manager generates 20% or more of the revenue of the

business units supervised by the branch office manager's supervisor.¹¹ Dealers must calculate the 20% threshold in the same manner as when determining whether a producing manager must be subject to heightened supervision, as described below.

Supervisory Control System

The amendments also include new section (f), derived from NASD Rule 3012, which incorporates the following new requirements:

Testing and Verification of Supervisory Control Procedures. Section (f) requires dealers to designate and identify one or more principals charged with establishing, maintaining and enforcing a system of "supervisory control policies and procedures" that:

- test and verify that a dealer's supervisory procedures are reasonably designed to achieve compliance with the federal securities laws and MSRB rules; and
- create additional or amended supervisory procedures where a need for such procedures is identified by such testing.

Annual Submission of Report to Senior Management. At least once annually, the principal(s) designated under section (f) must submit a report to senior management that details the dealer's supervisory control policies and procedures, summarizes the results of

¹¹ The 2004 NTM provides examples of such heightened inspection procedures under NASD Rule 3010, including, without limitation, unannounced office inspections; increasing the frequency of inspections; broadening the scope of activities inspected; and/or having one or more principals review or approve the inspection. The MSRB would view these examples as equally applicable to the heightened inspection procedures required under Rule G-27(d)(iii).

testing and identifies significant weaknesses, and discusses additional or amended procedures implemented in response to such testing.

The Board recognizes that situations may arise where a dealer is required under the rules of another self-regulatory organization to produce a similar report. The Board does not intend for a dealer to produce duplicative reports in such situations. Instead, for purposes of this section (f), a dealer may prepare a single report so long as there is coordination in the preparation and submission of such report between any principal(s) designated by the dealer pursuant to the rules of another self-regulatory organization and the principal designated under Rule G-27(b)(ii)(C) or (f)(i). The dealer should adequately document such coordination between or among the various principals.

Supervision of Producing Manager's Customer Account Activity. Section (f) requires dealers to adopt procedures to review and supervise daily customer account activities of each branch office manager, sales manager, regional or district sales manager, or any person performing similar supervisory functions ("producing managers"). These policies and procedures must include "a means of customer confirmation, notification, or follow-up that can be documented." Specifically, the provision requires that policies and procedures must be reasonably designed to review and monitor the following activities:

- All transmittals of funds and securities to and from customer accounts;
- Changes of customer's address, including procedures to validate change of address; and

- Changes in customer investment objectives, including validation of such changes.¹²

Independent Review of Producing Manager. Section (f) requires an independent review of the producing manager. This review must be conducted by a person or persons who are senior to, or “otherwise independent” of, the producing manager. To be considered “otherwise independent” of the producing manager, the person performing the review:

- must not report, either directly or indirectly, to the producing manager he or she is reviewing;
- must be located at a different office than the producing manager;
- must not have supervisory authority over any of the activity under review, including not being directly compensated in whole or in part as a result of such activity; and
- must alternate such review responsibility with another person at least once every two years.

Section (f) also requires dealers to adopt, under certain circumstances, heightened supervisory procedures designed to avoid conflicts of interest arising from economic, commercial or financial interests that the supervisor holds in the person or activities being supervised. Such heightened supervisory procedures are required with respect to producing managers who are responsible for generating at least 20% of the revenue of the

¹² If a dealer does not engage in any of these activities, then the dealer’s supervisory control policies and procedures must note that the dealer is not engaged in these activities and that the supervisory control policies and procedures must be amended before the dealer may engage in such activities.

business which is supervised by the producing manager's supervisor.¹³ As noted above, the relevant provisions of Rule G-27 would apply if any portion of the 20% threshold is attributable to revenue generated through municipal securities transactions. However, the heightened supervision requirement does not apply where an otherwise independent person conducts the producing manager's reviews.

Finally, section (f) provides an exception from the independent review requirement if a dealer is so limited in size and resources that it is unable to identify anyone who is senior to or otherwise independent of the producing manager to conduct the review (the "limited size and resource" exception).

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The MSRB intends generally that the provisions of Rule G-27 be read consistently with the analogous NASD provisions, unless the MSRB specifically indicates otherwise. Thus, relevant NASD interpretations would be presumed to apply to the comparable MSRB provision, subject to the MSRB's right to make distinctions when necessary and appropriate. The MSRB recommends that dealers, including bank dealers, regularly visit or link to the relevant portions of the NASD Web site on supervision for current NASD interpretations of such analogous provisions.¹⁴ Furthermore, the MSRB intends to continue coordinating its requirements relating to supervision with those of the

¹³ The 2004 NTM provides examples of such heightened supervisory procedures under NASD Rule 3012, including, without limitation, unannounced supervisory reviews; increasing the frequency of supervisory reviews by different reviewers within a certain time period; broadening the scope of activities reviewed; and/or having one or more principals approve the supervisory review of such producing manager. The MSRB would view these examples as equally applicable to the heightened supervisory procedures required under Rule G-27(f)(ii)(C).

¹⁴ NASD's Web site on supervision is located at <http://www.nasd.com/RulesRegulation/IssueCenter/SupervisoryControl/index.htm>.

other relevant self-regulatory organizations in the securities markets whenever appropriate for dealers engaging in municipal securities transactions.

Finally, NASD Rule 3012 (Supervisory Control System) provides that “Any member in compliance with substantially similar requirements of the New York Stock Exchange, Inc. shall be deemed to be in compliance with the provisions of this Rule.” We note that the amendments to Rule G-27 incorporate substantially all of NASD Rule 3012. Therefore, the MSRB believes that any dealer in compliance with similar NASD or NYSE requirements would be deemed in compliance with the comparable requirements of Rule G-27(f), on supervisory control system, so long as there is coordination between or among any principal(s) designated by the dealer pursuant to the rules of NASD or the NYSE and the appropriate principal designated pursuant to Rule G-27(b)(ii)(C).

2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act,¹⁵ which provides that the MSRB’s rules shall: be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.

¹⁵ 15 U.S.C. 78o-4(b)(2)(C).

The MSRB believes that by conforming Rule G-27 to the relevant NASD rules on supervision and thereby making such requirements specifically applicable to the municipal securities activities of securities firms and bank dealers, the proposed rule change will promote regulatory consistency by facilitating dealer compliance with such requirements, as well as by facilitating the inspection and enforcement thereof.

B. Self-Regulatory Organization's Statement on Burden on Competition

The MSRB does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In April 2006 the MSRB published for comment draft amendments to Rule G-27 which incorporated most of the NASD requirements contained in Rules 3010 and 3012 in order to promote regulatory consistency and make these requirements specifically applicable to the municipal securities activities of securities firms and bank dealers. In response to its notice, the Board received two comment letters, both of which expressed support for the draft amendments. The Investment Company Institute (“ICI”) noted that conforming MSRB requirements to those of the NASD “will strengthen the current supervisory systems of municipal securities dealers because NASD rules require a more structured and formalized supervisory system than Rule G-27 in its current form.” ICI further stated that the proposal will “facilitate compliance by those dealers that are dually registered with the MSRB and the NASD...[and that this] conformity should also enable the NASD to

more efficiently inspect those dealers that are subject to rules of both self-regulatory organizations.”

The other commentator – BSC Securities – was supportive of the draft amendments but was concerned about “unintended consequences of rulemaking.” BSC noted that, as a small firm, it is particularly concerned with costs of compliance and therefore urged the Board to adopt provisions that are “identical (not ‘substantially similar’) to other SRO’s rules to ensure the coordination of regulatory approaches.” While the Board is sensitive to the costs of compliance, particularly in the case of smaller dealers, we believe that the amendments are appropriate and will result, as ICI stated, in “no substantive difference in the supervisory systems imposed by the rules of the MSRB and the NASD.”

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

The MSRB has proposed that the amendments become effective six months after Commission approval of the proposed rule change.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2006-10 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-MSRB-2006-10. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such

filing also will be available for inspection and copying at the MSRB's offices. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2006-10 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Florence E. Harmon
Deputy Secretary

¹⁶ 17 CFR 200.30-3(a)(12).