



National Examination Risk Alert

By the Office of Compliance Inspections and Examinations¹

In this Alert:

Topic: Regulatory concerns related to “Pay-to-Play” practices under MSRB rules.

Objectives: Provide a summary of the observations of SEC examiners with respect to firms engaged in municipal securities business, and their “Pay-to-Play” practices.

Key Takeaways:

Examinations have revealed a number of potential weaknesses regarding supervision of MSRB “Pay-to-Play” prohibitions.

Factors that firms might consider when evaluating their compliance and supervision policies and procedures in this area include strategies for improving surveillance and certification procedures.

In addition, firms are reminded of their obligation to keep written supervisory procedures current, and to provide regular training to Municipal Finance Professionals.

Volume II, Issue 4

August 31, 2012

“Pay-to-Play” Prohibitions for Brokers, Dealers and Municipal Securities Dealers under MSRB Rules

Introduction

This Risk Alert summarizes the observations of National Examination Program (“NEP”) examiners with respect to brokers, dealers or municipal securities dealers (collectively, “firms”) engaged in municipal securities business, and their practices related to contributions to political campaigns of public officials of issuers with whom they are doing or seek to do business (“Pay-to-Play”).² Moreover, this Risk Alert identifies areas of concern stemming from some recent examinations and sets forth a number of practices that some firms have elected to use.

By sharing this information, our intent is to alert senior management, risk managers, and legal and compliance personnel to

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² This Risk Alert only reflects observations with respect to broker-dealer’s obligations under current MSRB rules. It does not address any obligations of municipal advisors or swap advisors, for example. In addition, this Risk Alert does not address any obligations of investment advisers pursuant to the Investment Advisers Act of 1940.

these issues, encourage them to review compliance in these areas at their respective firms, and encourage improvements in compliance if applicable. The practices and issues described below are for informational purposes only. Their presentation is not intended as an endorsement of any particular practice as the staff recognizes that each firm must design its compliance structure based on a risk analysis that takes into account many factors. The practices described do not represent legal opinions or advice and may not necessarily represent legal or regulatory requirements. Depending on the characteristics of an organization, the described practices may not be applicable to a particular firm given its business or operations.

I. MSRB Rules Regarding Prohibitions on “Pay-to-Play” Practices³

Municipal Securities Rulemaking Board (“MSRB”) Rule G-37 generally prohibits firms⁴ from engaging in “municipal securities business” with an issuer for two years after any contributions have been made to an official of such issuer by the firm, a “municipal finance professional” (“MFP”) associated with the firm, or a political action committee controlled by the firm or MFP (a “controlled PAC”).⁵ There is an exception from this prohibition for a contribution of \$250 or less

³ See note 2.

⁴ Some banks or separately identifiable departments or divisions of banks are required to register with the Commission as municipal securities dealers under Exchange Act Section 15(B)(a) and are subject to MSRB rules.

⁵ As defined in MSRB Rule G-37, the term "municipal securities business" means:

(A) the purchase of a primary offering (as defined in rule A-13(f)) of municipal securities from the issuer on other than a competitive bid basis (*e.g.*, negotiated underwriting); or

(B) the offer or sale of a primary offering of municipal securities on behalf of any issuer (*e.g.*, private placement); or

(C) the provision of financial advisory or consultant services to or on behalf of an issuer with respect to a primary offering of municipal securities in which the dealer was chosen to provide such services on other than a competitive bid basis; or

(D) the provision of remarketing agent services to or on behalf of an issuer with respect to a primary offering of municipal securities in which the dealer was chosen to provide such services on other than a competitive bid basis.

per election made by an MFP to an official of an issuer for whom the MFP was entitled to vote (referred to herein as a “*de minimis* contribution”).⁶

An MFP is defined to include

- any associated person of a firm that primarily engages in municipal securities representative activities;⁷
- any associated person who solicits municipal securities business;⁸
- any associated person who is both a municipal securities principal or a municipal securities sales principal and a supervisor of any of the persons described in the two bullets above;
- certain supervisors, up to and including the CEO or similarly situated official or the officer(s) of a bank designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank’s municipal securities dealer activities; and
- any associated person who is a member of the firm’s executive or management committee or similarly situated officials, if any.

⁶ There are certain exemptions from the prohibitions under MSRB Rule G-37(i) and (j), *available at* <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx>.

⁷ These activities include one or more of the following:

(1) underwriting, trading or sales of municipal securities (provided, however, that sales activities with natural persons will not be considered to be municipal securities representative activities for purposes of Rule G-37);

(2) financial advisory or consultant services for issuers in connection with the issuance of municipal securities;

(3) research or investment advice with respect to municipal securities; or

(4) any other activities which involve communication, directly or indirectly, with public investors in municipal securities; *provided, however*, that the activities enumerated in subparagraphs (3) and (4) above shall be limited to such activities as they relate to the activities enumerated in subparagraphs (1) and (2) above.

⁸ Evidence of solicitation activities include, among other things, signing cover letters submitting responses to requests for qualifications (“RFQ”) for underwriting business and/or having the person’s name appear in responses to RFQs as a member of the underwriting team. *See, e.g., Southwest Securities, Inc.*, Exchange Act Rel. No. 61768 (Mar. 24, 2010).

Each person designated by the firm as an MFP retains this designation for one year after the last activity or position that gave rise to the designation. Non-MFPs can become MFPs once they solicit municipal securities business.⁹

Rule G-37 contains “look-forward” and “look-back” provisions.¹⁰ The basic look-back period is two years. This period starts to run from the making of a non-*de minimis* contribution to an official of the issuer by the firm, an MFP primarily engaged in municipal securities representative activities or solicitation activities associated with the firm, or a controlled PAC. During this two-year period there is a ban on engaging in municipal securities business with that issuer under MSRB Rule G-37(b)(i). The look-forward period is one year. During this period, which starts to run with the last activity or position that created MFP status for an individual, that person retains his or her status as an MFP. For persons who are MFPs solely by virtue of their supervisory or management-level activities, the look-back is shortened to six months under MSRB Rule G-37(b)(iii) and the look-forward is one year. For someone who is an MFP solely because of solicitation activities, MSRB Rule G-37(b)(ii) provides that the only contributions made by him or her to officials of an issuer during the two-year look-back period prior to becoming an MFP that would result in a ban on business would be those non-*de minimis* contributions made to an official of an issuer from whom such person has solicited business.¹¹

⁹ *Interpretive Notice on the Definition of Solicitation Under Rule G-37 and G-38*, dated June 8, 2006, available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-38.aspx?tab=2#_6E7D5C54-C56D-4DB5-BEC5-914028440CDC. This interpretation provides guidance as to what may or may not constitute a solicitation under Rules G-37 and G-38. It also states that the following would generally not be viewed as solicitations: communications with a conduit borrower, often a private entity; and payments made by a broker-dealer to third party consultants engaged to provide specific expert services incidental to completing the offering, for which the broker-dealer has already been retained by the issuer.

¹⁰ The look-back provision arises by operation of MSRB Rule G-37(b)(i) and the look-forward provision arises from the definition of “municipal finance professional” under MSRB Rule G-37(g)(iv). See MSRB Interpretive Notice 2006-15 (June 15, 2006), <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2006/2006-15.aspx>. MSRB Interpretive Notice on the Definition of Solicitation Under Rule G-37 and G-38, dated June 8, 2006, http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-38.aspx?tab=2#_6E7D5C54-C56D-4DB5-BEC5-914028440CDC. This interpretation provides guidance as to what may or may not constitute a solicitation under Rules G-37 and G-38. It also states that the following would generally not be viewed as solicitations: communications with a conduit borrower, often a private entity; and payments made by a broker-dealer to third party consultants engaged to provide specific expert services incidental to completing the offering, for which the broker-dealer has already been retained by the issuer. *Instructions for Forms G-37, G-37x and G-38t* (February 1, 2010), available at <http://www.msrb.org>.

¹¹ Since MSRB Rule G-37(b)(ii) and (iii), by their terms, apply to persons who are MFPs solely by virtue of their solicitation or supervisory/management activities, any such solicitor MFP or supervisory/management

Contributions of MFPs to issuers that may cause a firm to be banned from municipal securities business with an issuer are not limited to those contributions made by the MFPs while they are associated with a firm.¹² Specifically, the MSRB has provided that an individual that makes a *non-de minimis* contribution to an issuer official would cause any firm with which the individual becomes associated as an MFP during the two-year period following the contribution to be banned from the municipal securities business with the issuer.¹³ In addition, a *non-de minimis* contribution to an issuer official made by a person already associated with a firm but not then qualifying as an MFP would nonetheless cause the firm to be banned from municipal securities business with the issuer if that associated person becomes an MFP of the firm during the two-year period following the contribution.¹⁴

The rule also generally requires firms to file a Form G-37 with the MSRB by the last day of the month following the end of each calendar quarter (i.e., January 31, April 30, July 31 and October 31). Form G-37 requires a listing of the issuers with which the firm has engaged in municipal securities business during the calendar quarter.¹⁵ In addition, firms are required to disclose on Form G-37 all campaign contributions by the firm and certain campaign contributions by MFPs, non-MFP executive officers and controlled PACs to issuer officials, bond ballot campaigns and

MFP that engages in municipal securities representative activities for purposes of the rule would not qualify for the modified look-back periods described above.

¹² MSRB Questions and Answers Concerning Political Contributions and Prohibitions on Municipal Securities Business: G-37, available at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx> (“MSRB Q&A Guidance”), Q&A No. II.13 (May 24, 1994, revised October 30, 2003) and Q&A No. II.14 (December 7, 1994, revised October 30, 2003).

¹³ *Id.* The applicability of the two-year period is subject to the modified look back provisions for certain categories of MFPs described above.

¹⁴ MSRB Q&A Guidance, Q&A No. II.15 (May 24, 1994, revised October 30, 2003) and Q&A No. II.16 (June 29, 1998, revised October 30, 2003). The applicability of the two-year period is subject to the modified look back provisions for certain categories of MFPs described above.

¹⁵ This listing should be by state, along with the type of municipal securities business, e.g., whether serving as an underwriter (as part of a negotiated offering), as a dealer in an agency offering (such as a private placement or as a primary distributor for a 529 college savings plan), financial advisor and/or remarketing agent. *Instructions for Forms G-37, G-37x and G-38t* (February 1, 2010), available at <http://www.msrb.org>.

political parties of states or political subdivisions.¹⁶ Finally, Rule G-37 prohibits solicitation of any payments or coordination of any payments by firms and their MFPs in connection with contributions by others to an official of an issuer with which the firm is engaging or seeking to engage in municipal securities business, or to a political party of a state or locality where the firm is engaging or seeking to engage in municipal securities business.

MSRB Rule G-38 prohibits any firm from making any payment, directly or indirectly, to any person who is not an affiliated person of the firm to solicit municipal securities business (as defined in Rule G-37) on behalf of such firm.

The text of Rules G-37 and G-38, and the interpretive notices and letters relating to such rules, are available on the MSRB website at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx>.

II. Issues Observed in NEP Examinations Regarding Firm Compliance with MSRB Prohibitions on “Pay-to-Play” Practices

Based on recent NEP examinations of firms engaged in municipal securities business to assess their compliance with Rule G-37, the NEP has observed practices that raised the following concerns about firms’ compliance with their obligations under that rule and related rules applicable to such firms:¹⁷

- **Doing Municipal Business within the Two-Year Ban:** NEP staff have observed facts that suggest that some firms may have engaged in municipal securities business with issuers within two years of their MFPs making contributions other than *de minimis* contributions to officials of the issuers.

¹⁶ Contributions by MFPs (or non-MFP executive officer as defined in MSRB Rule G-37(g)(v)) of less than \$250 per election or per ballot campaign need not be disclosed on Form G-37 if the MFP or non-MFP executive officer is entitled to vote for the issuer official or ballot initiative. In addition, Rule G-37 does not require disclosure on Form G-37 of payments made by an MFP or non-MFP executive officer of a political party of a state or a political subdivision in which such person is entitled to vote if all payments by such person to such political party, in total, do not exceed \$250 per year.

¹⁷ In addition to MSRB Rule G-37, these practices may also implicate supervisory obligations of brokers, dealers and municipal securities dealers under MSRB Rule G-27 over their municipal securities activities and those of their associated persons...

- **Recordkeeping:** NEP staff observed facts that suggest that some firms examined may not have maintained accurate and complete lists of their MFPs and Non-MFP executive officers as required by MSRB Rule G-8.¹⁸
- **Failure to File Form G-37:** NEP staff observed facts that suggest that firms may have failed to file accurate and complete Form G-37s, such as identification on that form of all municipal securities business in which a firm was engaged or all political contributions made to issuer officials by MFP and non-MFP executive officers.¹⁹
- **Inadequate Supervision:** NEP staff has observed facts that suggest that some firms examined may have failed to establish or implement adequate supervisory procedures to ensure compliance with MSRB Rules G-37 and G-38.²⁰ Once a firm has designed procedures to ensure compliance with the rules, it must also implement those procedures.

III. Staff Observations of Compliance Programs Related to MSRB “Pay-to-Play” Prohibitions

The staff has been informed by firms that they design compliance programs regarding pay-to-play practices in the light of a complex matrix of relevant legal obligations including, in addition to MSRB rules, other federal, state and local requirements related to bidding for government business, election law, employment law, privacy requirements, etc. The nature of these aggregated legal obligations varies depending on a firm’s size, the types of business that it conducts and the states or localities in which it conducts business. Consequently, the NEP staff has observed that firms follow a wide range of different approaches to compliance policies and procedures in this area that are described below. This description of observed practices is not

¹⁸ MSRB Rule G-8 requires firms to maintain accurate and complete lists of their MFPs and Non-MFP executive officers. See <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-8.aspx>.

¹⁹ Some firms recently examined failed to identify all of the municipal securities business in which the firms engaged. Several failed to identify all political contributions made to issuer officials by MFP and non-MFP executive officers.

²⁰ The staff observed that some firms recently examined had procedures that appeared to be inadequate to comply with Rules G-37 and G-38. Other firms had procedures designed to ensure compliance with Rules G-37 and G-38, but failed to implement these procedures.

exhaustive. Other practices besides those described below may be appropriate to consider, and some of the practices may not be applicable to a particular firm's business.

The staff has observed the following steps that certain firms have taken with respect to "Pay-to-Play" prohibitions under MSRB rules as well as other applicable legal requirements.

- **Training to MFPs:** Many firms provide regular training for MFPs on the requirements of MSRB Rules G-37 and G-38, and document the training received by the MFPs.²¹ Such training serves as an important supplement to surveillance, particularly during years in which political contributions are likely to be higher, such as presidential election years.²²
- **Self-certification.** Some firms also require MFPs, non-MFP executive officers and employees who could become MFPs to certify on an annual or other periodic basis that they understand and are abiding with all firm requirements regarding political contributions.
- **Surveillance:** Some firms use various resources, such as the internet, to search for political contributions made by any of their MFPs, non-MFP executive officers and employees who could become MFPs (e.g., www.fec.gov and a number of non-governmental sites) to ensure that these employees are accurately reporting their political contributions to the firms and, as applicable, to determine whether such contributions were reported on the firm's Form G-37 filings. Moreover, these firms may screen e-mails and other communications to ascertain whether MFPs or non-MFP executive officers have made any unreported contributions.
- **Two-Year Look-back.** Some firms have adopted procedures to identify non-MFPs who may become MFPs in the future as a result of a promotion or change in responsibilities. NEP staff observed that these firms subject such employees to the firm's political contribution requirements prior to becoming MFPs to mitigate the impact of any required look-back under Rule G-37. In addition, NEP staff observed that some firms survey potential employees about their political contributions to determine whether the applicant

²¹ Training programs are often set up by firms to comply with the continuing education requirements of MSRB Rule G-3(h) and as a supplement to, or as part of, a supervisory plan required by MSRB Rule G-27.

²² Firms should make certain their written supervisory procedures comport with MSRB Rule G-27 and are up to date with MSRB guidance regarding supervision and "Pay-to-Play" practices.

made any contributions that could impact the firm’s municipal securities business under Rules G-37 and G-38.

- **Pre-Clearance or Restrictions on Political Contributions.**²³ NEP staff have observed a range of steps taken by some firms, in light of the matrix of diverse federal, state and local requirements described on page 7 above, to pre-clearing or restricting political contributions, such as the following three approaches.
 - **Preclearance of Political Contributions by MFPs.** NEP staff have observed that many firms require pre-clearance of political contributions by MFPs. Some firms structure their internal approval program so that MFPs must seek approval from compliance or a similar group within the firm.²⁴
 - **Pre-Clearance of Political Contributions by non-MFPs:** NEP staff have observed that some firms have determined to require some level of pre-clearance of political contributions beyond just MFPs. In some instances these firms have set different thresholds for employee pre-clearance based on factors such as the employee’s status and the particular functions or activities for which the employee is responsible. At higher risk levels these firms may require preclearance of all political contributions, including federal, since a federal official may be running for a state office, while at lower risk levels they may only require preclearance of contributions in connection with local political races. Some firms apply a similar risk analysis to determine whether to require preclearance of political contributions by immediate household members of certain employees. As with MFP preclearance, some firms structure their internal approval program so that covered employees must seek approval from compliance or a similar group within the firm.

²³ MSRB rules do not require pre-clearance of employee political contributions, and NEP staff does not believe pre-clearance procedures are a necessary component of a firm’s supervisory procedures and compliance controls with respect to “Pay-to-Play” prohibitions under MSRB rules.

²⁴ As discussed below, in conversations with firms some have indicated a need to ensure a clear separation between the group providing approval and other management or human resources functions within the firm to avoid the appearance that decisions related to the terms or conditions of employment are influenced by political orientation.

- **Prohibition on political contributions.** While not required by MSRB rules, some firms have chosen to prohibit any non-*de minimis* political contributions by MFPs or prospective MFPs as a condition of employment, to the extent permitted by state or local law. As part of this analysis, such firms have made a determination that the jurisdictions where they operate allow such prohibitions.
- **Separation of Functions.** Some firms have told us that they provide separation between, on the one hand, functions such as preclearance, look-backs, or surveillance, and on the other hand, functions that could influence an employee’s terms of employment, such as management and human resources. This separation is intended to protect an employee against any possibility that an adverse action could be taken based on the employee’s political preferences.

Conclusion

This alert informs firms engaged in municipal securities business about areas of concern identified in NEP examinations of compliance with prohibitions on MSRB “Pay-to-Play” practices. It also describes observations by the Examination staff regarding supervisory practices and controls for compliance with MSRB rules that some firms have elected to adopt with respect to prohibitions on “Pay-to-Play” practices in the context of municipal securities activities. However, it does not purport to provide a list of steps to effectively discharge responsibilities and does not address the requirements for other types of registered entities or pay-to-play prohibitions under other regulatory regimes.

The staff hopes that sharing observations from recent examinations is helpful to firms in strengthening their compliance and risk management programs related to municipal securities, and welcomes comments and suggestions about how the NEP can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified in the course of examinations regarding compliance by firms with municipal securities pay-to-play prohibitions under MSRB rules. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks and issues, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, and they constitute neither a safe harbor nor a “checklist.” Other factors besides those described in this Risk Alert may be appropriate alternatives or supplements to consider. The risks, issues and associated factors described are for informational purposes only. They do not necessarily represent legal or regulatory requirements. They do not present any legal opinion or advice. Moreover, future changes in laws or regulations may supersede some or all of the discussion in this Alert. Some of these risks, issues and associated factors may not be applicable to a particular firm given the characteristics of its business or operations. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
