limits depend upon the height above mean sea level of the offshore transmitting antenna and the distance between the antenna location of the offshore transmitter and the antenna location of the main transmitter of the nearest full-service television station that transmits on the TV channel containing the channel on which the offshore station transmits.

(2) *Adjacent channel protection.* The ERP of offshore stations located within 128.8 kilometers (80 miles) of the main transmitter antenna of a full service TV station that transmits on a TV channel adjacent to the TV channel which contains the channel on which the offshore station transmits must not exceed the limits in the Table I–2 of § 22.1015. The limits depend upon the height above mean sea level of the offshore transmitting antenna and the distance between the location of the offshore transmitter and the 4.8 kilometer (3 mile) limit.

TABLE I–1.—MAXIMUM ERP (WATTS)

Distance	30 meters (100 feet)	45 meters (150 feet)	61 meters (200 feet)
338 km (210 mi)	1000	1000	1000
330 km (205 mi)	1000	900	800
322 km (200 mi)	800	710	630
314 km (195 mi)	590	520	450
306 km (190 mi)	450	400	330
298 km (185 mi)	320	280	240
290 km (180 mi)	250	210	175
282 km (175 mi)	180	150	130
274 km (170 mi)	175	110	100
266 km (165 mi)	95	80	70
258 km (160 mi)	65	55	50
249 km (155 mi)	50	40	35
241 km (150 mi)	35	30	25

§ 22.1015 Repeater operation.

Offshore central stations may be used as repeater stations provided that the licensee is able to maintain control of the station, and in particular, to turn the transmitter off, regardless of whether associated subscriber stations are transmitting at the time.

TABLE I–2.—MAXIMUM ERP (WATTS)

Distance from the 4.8 km (3 mi) limit	30 meters (100 feet)	61 meters (200 feet)
6.4 km (4 mi)	25	6
8.0 km (5 mi)	40	10
9.7 km (6 mi)	65	15
11.3 km (7 mi)	100	25
12.9 km (8 mi)	150	35
14.5 km (9 mi)	215	50
16.1 km (10 mi)	295	70
17.7 km (11 mi)	400	100
19.3 km (12 mi)	530	130
20.9 km (13 mi)	685	170
22.5 km (14 mi)	870	215
24.1 km (15 mi)	1000	270
25.7 km (16 mi)	1000	415
27.4 km (17 mi)	1000	505
29.0 km (18 mi)	1000	610
30.6 km (19 mi)	1000	730
32.2 km (20 mi)	1000	865
33.8 km (21 mi)	1000	1000

§ 22.1025 Permissible communications.

Offshore central stations must communicate only with subscriber stations (fixed, temporary-fixed, mobile and airborne). Offshore subscriber stations must normally communicate only with and through offshore central stations. Stations in the Offshore Radiotelephone Service may communicate through relay stations authorized in this service.

§ 22.1031 Temporary fixed stations.

The FCC may, upon proper application therefor, authorize the construction and operation of temporary fixed stations in the Offshore Radiotelephone service to be used only when the service of permanent fixed stations is disrupted by storms or emergencies or is otherwise unavailable.

(a) *Six month limitation.* If it is necessary for a temporary fixed station to remain at the same location for more than six months, the licensee of that station must apply for authorization to operate the station at the specific location at least 30 days before the end of the six month period.

(b) *International communications.* Communications between the United States and Mexico must not be carried using a temporary fixed station without prior authorization from the FCC. Licensees desiring to carry such communications should apply sufficiently in advance to allow for the time necessary to coordinate with Canada or Mexico.

§ 22.1035 Construction period.

The construction period (see § 22.142) for offshore stations is 18 months.

§ 22.1037 Application requirements for offshore stations.

Applications for new Offshore Radiotelephone Service stations must contain an exhibit showing that:

(a) The applicant has notified all licensees of offshore stations located within 321.8 kilometers (200 miles) of the proposed offshore station, by providing the following data, at least 30 days before filing the application:

(1) The name, business address, channel coordinator, and telephone number of the applicant;

(2) The location and geographical coordinates of the proposed station;

(3) The channel and type of emission;

(4) The height and type of antenna;

(5) The bearing of the main lobe of the antenna; and,

(6) The effective radiated power.

(b) The proposed station will not interfere with the primary ORS channels by compliance with the following separations:

(1) Co-channel to a distance of 241.4 kilometers (150 miles).

(2) If interstitial channels are used, adjacent channels (±12.5 kHz) to a distance of 80.5 kilometers (50 miles).

(3) Third order intermodulation channels (±12.5 kHz) to a distance of 32.2 kilometers (20 miles).

(4) If the proposed transmitting antenna site is located west of longitude W.93°40′, and within 32.2 kilometers (20 miles) of the shoreline, and proposed use of the channels listed in § 22.1007(b), no third-order intermodulation interference would be caused to any base or mobile station using the channels between 488 and 494 MHz.

[FR Doc. 94–27415 Filed 11–16–94; 8:45 am]

BILLING CODE 6712–01–M

Thursday
November 17, 1994

Part III

Department of Education

34 CFR Parts 75 and 76

Direct Grant Programs and State-Administered Programs; Final Rule

DEPARTMENT OF EDUCATION

34 CFR Parts 75 and 76

RIN 1880–AA50

Direct Grant Programs and State-Administered Programs

AGENCY: Department of Education.

ACTION: Final regulations.

SUMMARY: The Secretary amends the Department's regulations on direct grant programs and State-administered programs to clarify the requirements and procedures for establishing and applying indirect cost rates under programs administered by the Department.

EFFECTIVE DATE: These regulations take effect on December 19, 1994.

FOR FURTHER INFORMATION CONTACT: Glenn Riley, U.S. Department of Education, 400 Maryland Avenue, S.W., Room 3636, ROB–3, Washington, D.C. 20202–4700. Telephone: (202) 708–7640. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339 between 8 a.m. and 8 p.m., Eastern time, Monday through Friday.

SUPPLEMENTARY INFORMATION: On January 14, 1994, the Secretary published in the **Federal Register** (59 FR 2480) a notice of proposed rulemaking (NPRM) proposing to revise certain sections in the Education Department General Administrative Regulations (EDGAR) on indirect cost rates. These proposed revisions were intended to improve the administration of discretionary grants and to clarify for grantees the procedures and requirements of the Department.

The proposed regulations addressed a number of problems in this area of grants administration, including the computation and use of restricted indirect cost rates in programs with a statutory supplement-not-supplant requirement, the definition of a training grant, and the use of indirect costs as matching or cost-sharing.

Significant differences between the NPRM and this final regulation include changes to §§ 75.561 and 76.561 to allow State educational agencies to approve multi-year indirect cost rates for local educational agencies, the deletion of research training programs from the definition of a training grant in § 75.562, and the inclusion of a definition of "modified total direct cost base," also in § 75.562.

Analysis of Comments and Changes

In response to the Secretary's invitation in the NPRM, 21 parties submitted comments on the proposed regulations. An analysis of the comments and of the resulting changes in the regulations follows.

Substantive issues are discussed under the section of the regulations to which they pertain. Technical and other minor changes—and suggested changes the Secretary is not legally authorized to make under the applicable statutory authority—are not addressed.

Section 75.560 General Indirect Cost Rates; Exceptions

Since the Department recently adopted the revised OMB Circular A–110 as 34 CFR Part 74, references in this section have been revised to be consistent with the new Part 74.

Comments: Several parties commented on the requirement that a recipient have a current indirect cost rate agreement to charge indirect costs to a grant, asking what should happen if a recipient has submitted an indirect cost proposal but has not received approval from the Department. One suggested that the Department should assign an indirect cost rate based on the applicant's last approved rate and another thought the applicant should be allowed to use its proposed rate.

Discussion: The Department now allows six months to review a rate proposal and negotiate a new rate, which is generally adequate time to complete the process. If for some reason a rate has not been approved on time, the use of a temporary rate would be considered by the Department. Since other changes to these regulations give the Department authority to establish temporary rates, no additional changes concerning temporary rates are necessary.

Changes: None.

Comments: Another commenter asked about the effect of the proposed regulations on contractors under a grant and whether this section requires contractors to obtain a rate, including a temporary rate if necessary, from the Department.

Discussion: Many contractors already have a negotiated indirect cost rate because they are direct recipients of Federal funds. Under current procedures State and local governments are expected to assign an indirect cost rate to a contractor or other lower tier organization that does not already have one. Thus State educational agencies assign rates to their local educational agencies (see § 75.561). These regulations do nothing to change these practices and contractors or other lower tier organizations are not expected to negotiate a rate with the Department.

Changes: None.

Section 75.561 Approval of indirect cost rates.

Comments: Several commenters were confused by the statement in § 75.561(c) that the Secretary approves indirect cost rate agreements, an apparent conflict with the practice of the cognizant agency negotiating a rate with an applicant.

Discussion: The Secretary does negotiate indirect cost rates with applicants, but only when the Department is the cognizant agency. A change has been made to clarify this paragraph.

Changes: Section 75.561(a) has been revised to make it clear that the Secretary approves indirect cost rates for applicants when the Department is the cognizant agency.

Comments: One commenter suggested that State educational agencies have the same flexibility to approve multi-year indirect cost rates as the proposed revision to § 75.561 would give the Secretary. The commenter observed that it would be more cost-effective, particularly for small local educational agencies, to have rates in effect for more than one year.

Discussion: The Secretary agrees with this comment and has made a change.

Changes: Section 75.561(b) has been revised to allow State educational agencies to approve indirect cost rates—for local educational agencies—that are in effect for more than one year.

Section 75.562 Indirect cost rates for educational training projects.

Comments: A commenter objected to the inclusion of research training programs in the proposed definition of an educational training grant, observing that OMB Circular A–21 specifies that research training is part of an institution's sponsored research activities.

Discussion: OMB Circular A–21, in Section B, Definition of Terms, states that the term "sponsored research" includes "activities involving the training of individuals in research techniques (commonly called research training) * * *." In order to be consistent with this circular, the Secretary has made a change in the definition of an educational training grant.

Changes: The phrase "including special research training programs" has been deleted from the definition of an educational training grant in § 75.562(a).

Comments: A few commenters thought that the definition of a training grant was ambiguous and too broad. One suggested that it be limited to grants that were designated as training grants by statute or where the grant includes such costs as tuition and fees (so-called "flow-through" funds) that are used by the recipient to cover a portion of its indirect costs. Another asked if the Secretary would be using this definition in determining which grants are training grants, as stated in § 75.562(b).

Discussion: The fact that the proposed definition of a training grant is broad and comprehensive is a reflection of the great variety of grants administered by the Department that are training grants. The definition suggested by the commenter would overly limit the designation of training grants and exclude certain programs that clearly are primarily for the provision of training. The intent of the definition is to provide the public with the criteria used by the Secretary in determining what is a training grant and a change has been made to make this clear.

Changes: Section 75.562(b) has been revised to indicate that the Secretary does use the definition of a training grant in paragraph (a) in determining which grants are educational training grants.

Comments: Several commenters objected to the Department's use of the eight percent limit on training grants and thought the rate negotiated by the recipient with its cognizant agency should be employed instead.

Discussion: Since its inception, the Department has consistently maintained the necessity of limiting the indirect cost rate on training grants. This policy was originally established when the Department was a component of the Department of Health, Education, and Welfare, now the Department of Health and Human Services (HHS). This policy is still in effect at HHS and is intended in part to maximize the number of projects funded under these programs. In addition, a number of training projects contain significant amounts of flow-through funds and therefore do not carry the same burden of overhead or administrative costs as do other projects. The Secretary does not agree that the recipients of training grants should be reimbursed at their full negotiated rates and no change in this section has been made.

Changes: None.

Comments: Nine comments were received on the proposed revision to § 75.562(c) that would require the training rate of eight percent to be applied to a modified total direct cost base, instead of using a base of total direct costs as in the current regulation. Commenters opposed this change on grounds that it would further reduce a grantee's ability to recover legitimate indirect costs under training grants and reduce the number of organizations that could afford to apply for those grants. Several commenters also asked for a definition of "modified total direct cost base."

Discussion: There is general agreement in the grants community that indirect costs should not be charged to activities that do not have significant administrative costs associated with them, such as "flow-through funds" (e.g., tuition, fees, and stipends). The Secretary proposed to revise these regulations to be consistent with this principle and to clarify for all interested parties what base should be used in computing indirect costs under a training grant. Though this change will reduce the indirect costs charged to the Department's grants for some recipients, the Secretary does not agree that the indirect cost base for training grants should include activities or costs that do not generate significant administrative expenses. However, the Secretary has made a change to clarify the term "modified total direct cost base."

Changes: Section 75.562(c) has been revised to include a definition of "modified total direct cost base." It has also been reworded to make it clearer that the paragraph is referring to the lesser amount of funds, not the lesser rate.

Comments: One commenter stated that the eight percent limitation should not apply to contractors under training grants, as required by § 75.562(c)(1), since not all contractors are in a position to absorb the costs not covered by the limited rate.

Discussion: If the contractor is not conducting training activities, the eight percent limitation would not apply and the contractor could use its negotiated rate. However, a contractor that is conducting training under a training grant would still be subject to the limitation of eight percent. No change has been made in this paragraph.

Changes: None.

Comments: Thirteen commenters objected to the requirement in § 75.562(c)(3) that indirect costs in excess of the eight percent limitation may not be used to satisfy cost-sharing or matching requirements. Many cited the new provision in OMB Circular A–110 that allows the use of unrecovered indirect costs for this purpose, with the approval of the granting agency. Commenters were concerned that this limitation would make it difficult for many competent applicants to qualify for grants that require cost-sharing or matching.

Discussion: The Department has a long-standing practice not to allow the use of unrecovered indirect costs under training grants as matching or cost-sharing. This practice was required because under a previous version of OMB Circular A–110 and the Department's implementing regulations in 34 CFR Part 74, only allowable costs could be used for matching or cost-sharing purposes. Since training grants are limited to an eight percent indirect cost rate, all indirect costs over that limit were considered unallowable and thus could not be used as matching or cost-sharing. The practice also had the result of maximizing the funds that support project activities, because the use of unrecovered indirect costs to meet matching or cost-sharing requirements would reduce the amount of direct cost funds being put into the project by the recipient.

The Department recently revised 34 CFR Part 74 to implement revisions to OMB Circular A–110. The circular and Part 74 now allow institutions of higher education, non-profit organizations, and hospitals that receive funds under Federal programs to use unrecovered indirect costs for matching or cost-sharing, but only with the approval of the awarding agency. In light of this change and in response to the concerns expressed by commenters, the Secretary re-examined this practice but decided not to change it because it maximizes the impact of the limited funds available for training grant programs.

Changes: None.

Comments: The Department received comments suggesting that applicants be notified as early as possible in the application process that a program is subject to the training rate or to the restricted rate based on a statutory supplement-not-supplant requirement. Commenters thought this information should be included in the application packages and also on the grant award notices.

Discussion: Many programs already include this information in application packages and notices, but, in an effort to assist applicants as much as possible, the Department will do this for the other programs as well. The issue is somewhat complicated by the fact that some, but not all, grants awarded under certain programs may be training grants. In this case the Department will include in the application package and notice a statement that some grants awarded under the program could be training grants subject to the eight percent limitation on indirect costs, depending upon the type of project proposed. The Department is already taking steps to include information in the Catalog of Federal Domestic Assistance that identifies those programs subject to the restricted rate based on the supplement-not-supplant requirement. As for placing the information on the award notices, the Department is currently redesigning its core financial systems, including the grants management system, and this information will be on award notices produced under the new system. These notification issues were not addressed in the proposed regulations and no change has been made to include them in the final regulations.

Changes: None.

Comments: A few commenters thought that the Department should exclude training grants and their indirect costs from the process used by the Department to establish indirect cost rates. This would have the effect of increasing the organization's negotiated rate and would offset somewhat the loss of indirect costs under the training grants.

Discussion: This issue was not included in the proposed regulations but will be considered by the Department during its periodic reviews of administrative procedures.

Changes: None.

Section 75.563 Restricted Indirect Cost Rate—Programs Covered

Comments: One commenter said that the restricted rates applicable to programs with the supplement-not-supplant requirement should not be applied to universities that have a negotiated indirect cost rate. They suggested that §§ 75.563 and 75.564(f) be deleted.

Discussion: The Department applies a restricted rate only to grants made under programs that have a statutory requirement that Federal funds be used to supplement, not supplant, institutional funds. If a recipient happens to be an institution of higher education, the restricted rate must be applied—the Department has no choice on the matter because the rate implements a statutory limitation. However, as a matter of practice, the recipients of grants under these programs are predominately State educational agencies or local educational agencies; very few institutions of higher education receive grants under restricted rate programs.

Changes: None.

Section 75.564 Reimbursement of Indirect Costs

Comments: Several commenters thought the language in § 75.564(a) was confusing and contradicts § 75.564(b) and § 75.560(d). They thought § 75.564(a) should be revised to make it clear that the Department accepts the rate negotiated with an applicant's cognizant agency.

Discussion: This section addresses the issue of reimbursement of indirect costs and the opening paragraph is a general statement of the Department's policies in this area. As stated in the first sentence, there are administrative and statutory restrictions that affect the reimbursement of indirect costs under programs administered by ED. There are also situations, though infrequent, when indirect costs are not reimbursed due to a lack of funds. This usually occurs when a grantee is seeking reimbursement of indirect costs because the applicable rate was adjusted upwards during or after the performance of the grant. The Secretary agrees that the second sentence in this section is somewhat confusing and has made a change.

Changes: The second sentence in § 75.564(a), "The extent to which indirect costs are reimbursed is a matter for determination between the Secretary and the grantee," has been deleted from the final regulation.

Comments: The Department received comments that construction grants and grants in support of conferences should not be included in the list of grants in § 75.564(c) for which indirect costs are unallowable. The commenters think these types of grants do carry considerable administrative costs and ED should reimburse recipients for their indirect costs. One commenter suggested that the language concerning conferences be revised to apply to grants made exclusively to support conferences.

Discussion: The Department does not agree that construction grants carry the same administrative costs as other types of grants. Most of the construction work funded by those grants is carried out under subcontracts, a practice which results in recipients incurring relatively little overhead expense in comparison to other types of grants. Also, unlike other products of grant-supported activities, the costs of a building can be recovered through depreciation or use allowances. Therefore no change has been made concerning construction grants, but the language on grants for conferences has been revised.

Changes: Section 75.564(c)(6) has been revised to apply to grants made exclusively to support conferences.

Comments: Several commenters thought § 75.564(e) prohibits the use of indirect costs to satisfy matching or cost-sharing requirements and so should be revised or deleted as inconsistent with OMB Circulars A–21 and A–110.

Discussion: The OMB circulars that serve as cost principles or administrative guidance for grant recipients all contain the requirement that only allowable costs may be charged to a Federal grant as either direct or indirect costs. The same principle applies to funds used for matching or cost-sharing. However, the re-statement of this principle in these regulations has caused some confusion, particularly since a change to OMB Circular A–110, recently adopted by the Department as 34 CFR Part 74, gives granting agencies the option of approving unrecovered indirect costs to satisfy matching or cost-sharing requirements. The Department has therefore decided to delete the proposed § 75.564(e) from the final regulations.

As discussed elsewhere in this document, the Department is continuing its practice of prohibiting the use of unrecovered indirect costs to satisfy matching or cost-sharing requirements under training and restricted rate grants. For grantees subject to 34 CFR Part 74, the Department will consider on a case-by-case basis requests to use unrecovered indirect costs as matching or cost-sharing when the grant in question is not a training grant or a grant subject to a restricted indirect cost rate.

Changes: The proposed § 75.564(e) has been deleted.

Comments: The Department received one comment that § 75.564(f) should be deleted and each member of a group of eligible parties be allowed to apply its own indirect cost rate to its portion of the grant funds.

Discussion: It has been the Department's policy on certain indirect cost matters—for example, the eight percent training rate—to maximize the Federal funds going to support program activities. If the official recipient of the grant applies its rate to the full award amount and each member of the group applies its full rate to its portion of the grant, as has happened in such situations, a disproportionate amount of the grant is spent on indirect costs. Since the Department wishes to maximize the funds supporting the direct costs of a project, it is limiting the indirect costs for grants made to groups of eligible parties to the rate of the official grant recipient, the fiscal agent for the group. The members of the group can decide among themselves how the funds should be divided within the group.

Changes: No change was made to the text of this paragraph, but, since the proposed § 75.564(e) has been deleted, this paragraph has been redesignated as § 75.564(e) in these final regulations.

Section 76.560 General indirect cost rates; exceptions.

Since the Department recently adopted the revised OMB Circular A–110 as 34 CFR Part 74, references in this section have been revised to be consistent with the new 34 CFR Part 74.

Section 76.561 Approval of indirect cost rates.

The Department has revised this section to be consistent with the corresponding section of 34 CFR Part 75 so that State educational agencies may approve multi-year indirect cost rates for recipients subject to 34 CFR Part 76.

Section 76.564 Restricted indirect cost rate—formula.

The Department has made a revision to this section to make its requirements consistent with similar requirements in 34 CFR Part 75. Specifically, § 76.564(d) has been revised to prohibit the use of unrecovered indirect costs under a restricted rate grant to satisfy matching or cost-sharing requirements. This change is consistent with current departmental practices and with the restriction placed on training grants in § 75.562(c)(3).

Section 76.565 General management costs—restricted rate.

Comments: Several commenters found the language in § 76.565 concerning organization-wide activities to be unclear. Some of the commenters thought that the proposed regulations did not make it clear that some activities considered divisional administration may in fact be organization-wide activities, such as payroll or personnel functions.

Discussion: The Department agrees with these commenters and has changed the wording in an attempt to make the final version clearer to readers.

Changes: The wording of § 76.565(a) has been changed to clarify the meaning of the term organization-wide. Section 76.565(c) has been revised to clarify the use of the term divisional administration.

Comments: One commenter said a deputy chief executive officer who oversees general management activities should not be excluded as required in § 76.565 (c) and (d). Another said that chief executive officers should be excluded only if their activities are limited to one component.

Discussion: Chief executive officers and their deputies are positions that would exist whether or not the organization received Federal funds. To support them with Federal funds would be supplanting, which is prohibited under restricted rate programs.

Changes: None.

Comments: One commenter disagreed with the definition of component in § 76.565(d)(2), saying it conflicts with the generally accepted accounting standard that an agency is a component of a State. The commenter maintains that the proposed definition of a component as an organizational unit within an agency would prohibit States from charging legitimate administrative costs to a grant.

Discussion: As stated in § 76.563, this section applies to "agencies of State and local governments," most commonly the State educational agency, not to the State itself. In this context, the component would be an organizational unit within a State agency, as described in the regulation. No change has been made in this section.

Changes: None.

Section 76.567 Other expenditures—restricted rate.

Comments: The Department received one comment that subgrants should be excluded from other expenditures, since their inclusion would distort the indirect cost calculation and subgrants are already excluded from the base in the formula in § 76.569.

Discussion: The Department agrees with this comment and has made a change.

Changes: Section 76.567(b) has been revised to exclude subgrants from other expenditures.

Section 76.568 Occupancy and space maintenance costs—restricted rate.

Comments: One commenter thought the last two sentences of § 76.568(c) should be deleted as inconsistent with other Federal guidance in OMB Circular A–87 and OASC–10, that States cannot afford to pay for the office space occupied by Federal program staff.

Discussion: The sentences in question are not intended to indicate that the costs of office space for Federal program staff must be borne by the States, nor are they inconsistent with other Federal guidance. Costs of space can be charged as indirect or direct costs as appropriate, but Federal funds cannot be used to supplant local funds under programs with statutory prohibitions of supplanting. The last sentence merely reiterates the standard practice that the Secretary approves the budgets of projects supported by grant funds. No changes have been made to this section.

Changes: None.

Paperwork Reduction Act of 1980

These regulations have been examined under the Paperwork Reduction Act of 1980 and have been found to contain no information collection requirements.

Assessment of Educational Impact

In the notice of proposed rulemaking, the Secretary requested comments on whether the proposed regulations would require transmission of information that is being gathered by or is available from any other agency or authority of the United States.

Based on the response to the proposed rules and on its own review, the Department has determined that the regulations in this document do not require transmission of information that is being gathered by or is available from any other agency or authority of the United States.

List of Subjects 34 CFR Part 75

Education Department, Grant programs—education, Grant administration, Incorporation by reference.

List of Subjects in 34 CFR Part 76

Education Department, Grant programs—education, Grant administration, Intergovernmental relations, State-administered programs.

(Catalog of Federal Domestic Assistance Number does not apply.)

Dated: November 10, 1994.

Richard W. Riley,

Secretary of Education.

The Secretary amends Parts 75 and 76 of Title 34 of the Code of Federal Regulations as follows:

PART 75—DIRECT GRANT PROGRAMS

1. The authority citation for Part 75 continues to read as follows:

Authority: 20 U.S.C. 1221e–3(a)(1) and 3474, unless otherwise noted.

2. Section 75.129 is amended by revising paragraphs (a) (1) and (2) and adding paragraph (a)(3), to read as follows:

§ 75.129 Legal responsibilities of each member of the group.

(a) * * *

(1) The use of all grant funds;

(2) Ensuring that the project is carried out by the group in accordance with Federal requirements; and

(3) Ensuring that indirect cost funds are determined as required under § 75.564(e).

* * * * *

3. Section 75.560 is amended by revising paragraphs (a) (1), (2), (3), (4), and (5), by revising paragraph (b), by adding new paragraphs (c) and (d), by and revising the authority citation at the end of the section, to read as follows:

§ 75.560 General indirect cost rates; exceptions.

(a) * * *

(1) Institutions of higher education, at 34 CFR 74.27;

(2) Hospitals, at 34 CFR 74.27;

(3) Other nonprofit organizations, at 34 CFR 74.27;

(4) Commercial (for-profit) organizations, at 34 CFR 74.27; and

(5) State and local governments and federally-recognized Indian tribal organizations, at 34 CFR 80.22.

(b) A grantee must have a current indirect cost rate agreement to charge indirect costs to a grant. To obtain an indirect cost rate, a grantee must submit an indirect cost proposal to its cognizant agency and negotiate an indirect cost rate agreement.

(c) The Secretary may establish a temporary indirect cost rate for a grantee that does not have an indirect cost rate agreement with its cognizant agency.

(d) The Secretary accepts an indirect cost rate negotiated by a grantee's cognizant agency, but may establish a restricted indirect cost rate for a grantee to satisfy the statutory requirements of certain programs administered by the Department.

(Authority: 20 U.S.C. 1221e–3(a)(1) and 3474)

4. Section 75.561 is revised to read as follows:

§ 75.561 Approval of indirect cost rates.

(a) If the Department of Education is the cognizant agency, the Secretary approves an indirect cost rate for a grantee other than a local educational agency. For the purposes of this section, the term local educational agency does not include a State agency.

(b) Each State educational agency, on the basis of a plan approved by the Secretary, shall approve an indirect cost rate for each local educational agency that requests it to do so. These rates may be for periods longer than a year if rates are sufficiently stable to justify a longer period.

(c) The Secretary generally approves indirect cost rate agreements annually. Indirect cost rate agreements may be approved for periods longer than a year if the Secretary determines that rates will be sufficiently stable to justify a longer rate period.

(Authority: 20 U.S.C. 1221e–3(a)(1) and 3474)

5. Section 75.562 is revised to read as follows:

§ 75.562 Indirect cost rates for educational training projects.

(a) Educational training grants provide funding for training or other educational services. Examples of the work supported by training grants are summer institutes, training programs for selected participants, the introduction of new or expanded courses, and similar instructional undertakings that are separately budgeted and accounted for by the sponsoring institution. These grants do not usually support activities involving research, development, and dissemination of new educational materials and methods. Training grants largely implement previously developed materials and methods and require no significant adaptation of techniques or instructional services to fit different circumstances.

(b) The Secretary uses the definition in paragraph (a) to determine which grants are educational training grants.

(c) Indirect cost reimbursement on a training grant is limited to the recipient's actual indirect costs, as determined by its negotiated indirect cost rate agreement, or eight percent of a modified total direct cost base, whichever amount is less. For the purposes of this section, a modified total direct cost base is defined as total direct costs less stipends, tuition and related fees, and capital expenditures of $5,000 or more.

(1) The eight percent limit also applies to cost-type contracts under grants, if these contracts are for training as defined in this section.

(2) The eight percent limit does not apply to agencies of State or local governments, including federally recognized Indian tribal governments, as defined in 34 CFR 80.3.

(3) Indirect costs in excess of the eight percent limit may not be charged directly, used to satisfy matching or cost-sharing requirements, or charged to another Federal award.

(d) A grantee using the training rate of eight percent is required to have documentation available for audit that shows that its negotiated indirect cost rate is at least eight percent.

(Authority: 20 U.S.C. 1221e–3(a)(1) and 3474)

6. Section 75.563 is revised to read as follows:

§ 75.563 Restricted indirect cost rate—programs covered.

If a grantee decides to charge indirect costs to a program that has a statutory requirement prohibiting the use of Federal funds to supplant non-Federal funds, the grantee shall use a restricted indirect cost rate computed under 34 CFR 76.564 through 76.569.

(Authority: 20 U.S.C. 1221e–3(a)(1) and 3474)

7. Sections 75.564 through 75.568 are removed.

8. A new § 75.564 is added to read as follows:

§ 75.564 Reimbursement of indirect costs.

(a) Reimbursement of indirect costs is subject to the availability of funds and statutory or administrative restrictions.

(b) The application of the rates and the determination of the direct cost base by a grantee must be in accordance with the indirect cost rate agreement approved by the grantee's cognizant agency.

(c) Indirect cost reimbursement is not allowable under grants for—

(1) Fellowships and similar awards if Federal financing is exclusively in the form of fixed amounts such as scholarships, stipend allowances, or the tuition and fees of an institution;

(2) Construction grants;

(3) Grants to individuals;

(4) Grants to organizations located outside the territorial limits of the United States;

(5) Grants to Federal organizations; and

(6) Grants made exclusively to support conferences.

(d) Indirect cost reimbursement on grants received under programs with statutory restrictions or other limitations on indirect costs must be made in accordance with the restrictions in 34 CFR 76.564 through 76.569.

(e) Indirect costs for a group of eligible parties (see §§ 75.127–75.129) are limited to the amount derived by applying the rate of the applicant, or a restricted rate when applicable, to the grant in keeping with the terms of the applicant's indirect cost rate agreement.

(Authority: 20 U.S.C. 1221e–3(a)(1) and 3474)

PART 76—STATE-ADMINISTERED PROGRAMS

9. The authority citation for Part 76 continues to read as follows:

Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474, unless otherwise noted.

10. Section 76.560 is amended by revising paragraphs (a)(1), (2), (3), (4), and (5), by revising paragraph (b), by adding new paragraphs (c) and (d), and revising the authority citation at the end of the section, to read as follows:

§ 76.560 General indirect cost rates; exceptions.

(a) * * *

(1) Institutions of higher education, at 34 CFR 74.27;

(2) Hospitals, at 34 CFR 74.27;

(3) Other nonprofit organizations, at 34 CFR 74.27;

(4) Commercial (for-profit) organizations, at 34 CFR 74.27; and

(5) State and local governments and federally-recognized Indian tribal organizations, at 34 CFR 80.22.

(b) A grantee must have a current indirect cost rate agreement to charge indirect costs to a grant. To obtain an indirect cost rate, a grantee must submit an indirect cost proposal to its cognizant agency and negotiate an indirect cost rate agreement.

(c) The Secretary may establish a temporary indirect cost rate for a grantee that does not have an indirect cost rate agreement with its cognizant agency.

(d) The Secretary accepts an indirect cost rate negotiated by a grantee's cognizant agency, but may establish a restricted indirect cost rate for a grantee to satisfy the statutory requirements of certain programs administered by the Department.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

11. Section 76.561 is revised to read as follows:

§ 76.561 Approval of indirect cost rates.

(a) If the Department of Education is the cognizant agency, the Secretary approves an indirect cost rate for a State agency and for a subgrantee other than a local educational agency. For the purposes of this section, the term local educational agency does not include a State agency.

(b) Each State educational agency, on the basis of a plan approved by the Secretary, shall approve an indirect cost rate for each local educational agency that requests it to do so. These rates may be for periods longer than a year if rates are sufficiently stable to justify a longer period.

(c) The Secretary generally approves indirect cost rate agreements annually. Indirect cost rate agreements may be approved for periods longer than a year if the Secretary determines that rates will be sufficiently stable to justify a longer rate period.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2381(a), and 3474)

12. Section 76.563 is revised to read as follows:

§ 76.563 Restricted indirect cost rate—programs covered.

Sections 76.564 through 76.569 apply to agencies of State and local governments that are grantees under programs with a statutory requirement prohibiting the use of Federal funds to supplant non-Federal funds, and to their subgrantees under these programs.

(Authority: 20 U.S.C. 1221e(a)(1), 2831(a), 2974(b), and 3474)

13. A new § 76.564 is added to read as follows:

§ 76.564 Restricted indirect cost rate—formula.

(a) An indirect cost rate for a grant covered by § 76.563 or 34 CFR 75.563 is determined by the following formula:

Restricted indirect cost rate = (General management costs + Fixed costs) ÷ (Other expenditures)

(b) General management costs, fixed costs, and other expenditures must be determined under §§ 76.565 through 76.567.

(c) Under the programs covered by § 76.563, a subgrantee of an agency of a State or a local government (as those terms are defined in 34 CFR 80.3) or a grantee subject to 34 CFR 75.563 that is not a State or local government agency may use—

(1) An indirect cost rate computed under paragraph (a) of this section; or

(2) An indirect cost rate of eight percent unless the Secretary determines that the subgrantee or grantee would have a lower rate under paragraph (a) of this section.

(d) Indirect costs that are unrecovered as a result of these restrictions may not be charged directly, used to satisfy matching or cost-sharing requirements, or charged to another Federal award.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

14. A new § 76.565 is added to read as follows:

§ 76.565 General management costs—restricted rate.

(a) As used in § 76.564, *general management costs* means the costs of activities that are for the direction and control of the grantee's affairs that are organization-wide. An activity is not organization-wide if it is limited to one activity, one component of the grantee, one subject, one phase of operations, or other single responsibility.

(b) General management costs include the costs of performing a service function, such as accounting, payroll preparation, or personnel management, that is normally at the grantee's level even if the function is physically located elsewhere for convenience or better management. The term also includes certain occupancy and space maintenance costs as determined under § 76.568.

(c) The term does not include expenditures for—

(1) Divisional administration that is limited to one component of the grantee;

(2) The governing body of the grantee;

(3) Compensation of the chief executive officer of the grantee;

(4) Compensation of the chief executive officer of any component of the grantee; and

(5) Operation of the immediate offices of these officers.

(d) For purposes of this section—

(1) The chief executive officer of the grantee is the individual who is the head of the executive office of the grantee and exercises overall responsibility for the operation and management of the organization. The chief executive officer's immediate office includes any deputy chief executive officer or similar officer along with immediate support staff of these individuals. The term does not include the governing body of the grantee, such as a board or a similar elected or appointed governing body; and

(2) Components of the grantee are those organizational units supervised directly or indirectly by the chief executive officer. These organizational units generally exist one management level below the executive office of the grantee. The term does not include the office of the chief executive officer or a deputy chief executive officer or similar position.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

15. A new § 76.566 is added to read as follows:

§ 76.566 Fixed costs—restricted rate.

As used in § 76.564, *fixed costs* means contributions of the grantee to fringe benefits and similar costs, but only those associated with salaries and wages that are charged as indirect costs, including—

(a) Retirement, including State, county, or local retirement funds, Social Security, and pension payments;

(b) Unemployment compensation payments; and

(c) Property, employee, health, and liability insurance.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

16. A new § 76.567 is added to read as follows:

§ 76.567 Other expenditures—restricted rate.

(a) As used in § 76.564, *other expenditures* means the grantee's total expenditures for its federally- and non-federally-funded activities in the most recent year for which data are available. The term also includes direct occupancy and space maintenance costs as determined under § 76.568 and costs related to the chief executive officers of the grantee and components of the grantee and their offices (see § 76.565(c) and (d)).

(b) The term does not include—

(1) General management costs determined under § 76.565;

(2) Fixed costs determined under § 76.566;

(3) Subgrants;

(4) Capital outlay;

(5) Debt service;

(6) Fines and penalties;

(7) Contingencies; and

(8) Election expenses. However, the term does include election expenses that result from elections required by an applicable Federal statute.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

17. A new § 76.568 is added to read as follows:

§ 76.568 Occupancy and space maintenance costs—restricted rate.

(a) As used in the calculation of a restricted indirect cost rate, *occupancy and space maintenance costs* means such costs as—

(1) Building costs whether owned or rented;

(2) Janitorial services and supplies;

(3) Building, grounds, and parking lot maintenance;

(4) Guard services;

(5) Light, heat, and power;

(6) Depreciation, use allowances, and amortization; and

(7) All other related space costs.

(b) Occupancy and space maintenance costs associated with organization-wide service functions (accounting, payroll, personnel) may be included as general management costs if a space allocation or use study supports the allocation.

(c) Occupancy and space maintenance costs associated with functions that are not organization-wide must be included with other expenditures in the indirect cost formula. These costs may be charged directly to affected programs only to the extent that statutory supplanting prohibitions are not violated. This reimbursement must be approved in advance by the Secretary.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

18. A new § 76.569 is added to read as follows:

§ 76.569 Using the restricted indirect cost rate.

(a) Under the programs referenced in § 76.563, the maximum amount of indirect costs under a grant is determined by the following formula:

Indirect costs=(Restricted indirect cost rate)×(Total direct costs of the grant minus capital outlays, subgrants, and other distorting or unallowable items as specified in the grantee's indirect cost rate agreement)

(b) If a grantee uses a restricted indirect cost rate, the general management and fixed costs covered by that rate must be excluded by the grantee from the direct costs it charges to the grant.

(Authority: 20 U.S.C. 1221e–3(a)(1), 2831(a), 2974(b), and 3474)

[FR Doc. 94–28368 Filed 11–16–94; 8:45 am]

BILLING CODE 4000–01–P

federal register

Thursday
November 17, 1994

Part IV

Office of Management and Budget

Cumulative Report on Rescissions and Deferrals; Notice

OFFICE OF MANAGEMENT AND BUDGET

Cumulative Report on Rescissions and Deferrals

November 1, 1994.

This report is submitted in fulfillment of the requirement of Section 1014(e) of the Congressional Budget and Impoundment Control Act of 1974 (Public Law 93-344). Section 1014(e) requires a monthly report listing all budget authority for the current fiscal year for which, as of the first day of the month, a special message had been transmitted to Congress.

This report gives the status, as of November 1, 1994, of seven deferrals contained in the first Special Message for FY 1995. This message was transmitted to Congress on October 18, 1994.

Rescissions

As of November 1, 1994, no rescission proposals were pending before the Congress.

Deferrals (Table A and Attachment A)

As of November 1, 1994, $3,470.1 million in budget authority was being deferred from obligation. Attachment A shows the status of each deferral reported during FY 1995.

Information From Special Message

The special message containing information on the deferrals that are covered by this cumulative report is printed in the **Federal Register** cited below:

59 FR 54066, Thursday, October 27, 1994.

Alice M. Rivlin,

Director.

BILLING CODE 3110-01-M

TABLE A

STATUS OF FY 1995 DEFERRALS
(in millions of dollars)

	BUDGETARY RESOURCES
Deferrals proposed by the President................	3,525.1
Routine Executive releases through November 1, 1994	-55.0
Overturned by the Congress.........................	---
Currently before the Congress......................	3,470.1

ATTACHMENT A

Status of FY 1995 Deferrals - As of November 1, 1994

(Amounts in thousands of dollars)

Agency/Bureau/Account	Deferral Number	Amounts Transmitted: Original Request	Amounts Transmitted: Subsequent Change (+)	Date of Message	Releases(-): Cumulative OMB/ Agency	Releases(-): Congres-sionally Required	Congres-sional Action	Cumulative Adjust-ments (+)	Amount Deferred as of 11-1-94
FUNDS APPROPRIATED TO THE PRESIDENT									
International Security Assistance									
Economic support fund	D95-1	53,300		10-18-94					53,300
Foreign military financing grants	D95-2	3,139,279		10-18-94					3,139,279
Foreign military financing program account	D95-3	47,917		10-18-94					47,917
Military-to-military contact program	D95-4	2,000		10-18-94					2,000
Agency for International Development									
International disaster assistance, executive	D95-5	169,998		10-18-94	54,994				115,004
DEPARTMENT OF HEALTH AND HUMAN SERVICES									
Social Security Administration									
Limitation on administrative expenses	D95-6	7,319		10-18-94					7,319
DEPARTMENT OF STATE									
Bureau for Refugee Programs									
United States emergency refugee and migration assistance fund	D95-7	105,300		10-18-94					105,300
TOTAL, DEFERRALS		**3,525,113**			**54,994**				**3,470,118**

03-Nov-94

[FR Doc. 94–28393 Filed 11–16–94; 8:45 am]

BILLING CODE 3110–01–C

federal register

Thursday
November 17, 1994

Part V

Securities and Exchange Commission

17 CFR Part 240

Municipal Securities Disclosure; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–34961; File No. S7–5–94]

RIN 3235–AG13

Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting amendments to Rule 15c2–12 under the Securities Exchange Act of 1934 ("Exchange Act") to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. The amendments prohibit a broker, dealer, or municipal securities dealer ("Participating Underwriter") from purchasing or selling municipal securities unless the Participating Underwriter has reasonably determined that an issuer of municipal securities or an obligated person has undertaken in a written agreement or contract for the benefit of holders of such securities to provide certain annual financial information and event notices to various information repositories; and prohibit a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive promptly any event notices with respect to that security.

DATES: *Effective Date:* This rule is effective on July 3, 1995 except for § 240.15c2–12(c) which is effective on January 1, 1996.

Compliance Date: Sections 240.15c2–12(b)(5)(i)(A) and 240.15c2–12(b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996; and §§ 240.15c2–12(d)(2)(ii) and 240.15c2–12(d)(2)(iii) shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel, Janet W. Russell-Hunter, Attorney, or Paula R. Jenson, Senior Counsel (concerning the rule and release generally), (202) 942–0073, Office of Chief Counsel, Division of Market Regulation, Mail Stop 7–10; Gautam S. Gujral, Attorney (concerning information repositories) (202) 942–0175, Office of Market Supervision, Division of Market Regulation, Mail Stop 5–1, and David A. Sirignano, Senior Legal Adviser to the Director (202) 942–2870, or Amy Meltzer Starr, Attorney (concerning annual financial information, obligated persons, and material events generally), (202) 942–1875, Division of Corporation Finance, Mail Stop 7–6 Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary

The Commission has long been concerned with disclosure in both the primary and secondary markets for municipal securities.[1] As part of the Securities Acts Amendments of 1975, Congress established a limited regulatory scheme for the municipal securities market. This limited regulatory scheme included mandatory registration of municipal securities brokers and dealers, and the creation of the Municipal Securities Rulemaking Board ("MSRB"). In 1989, acting in response to consistently slow dissemination of information in connection with primary offerings of municipal securities, the Commission, pursuant to its authority under Exchange Act Section 15(c)(2),[2] adopted Rule 15c2–12[3] and an accompanying interpretation concerning the due diligence obligations of underwriters of municipal securities.[4] In 1993, the Commission's Division of Market Regulation conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure.[5] Findings in the September, 1993 *Staff Report on the Municipal Securities Market* ("*Staff Report*") regarding the growing participation of individual investors, who may not be sophisticated in financial matters, as well as the proliferation of complex derivative municipal securities, underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.[6] Information about the issuer and other obligated persons is as critical to the secondary market,[7] where little

[1] Both the Securities Act and the Exchange Act were enacted with broad exemptions for municipal securities from all of their provisions except the antifraud provisions of the Securities Act Section 17(a) and Exchange Act Section 10(b). Municipal securities received special exemptions not only based on considerations of federal-state comity, but also due to the lack of perceived abuses, at the time of enactment, in the municipal securities market as compared with the corporate market. Furthermore, until recently, the typical purchasers of municipal securities were institutional investors with financial expertise.

[2] Section 15(c)(2) of the Exchange Act prohibits municipal securities dealers from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any municipal security by means of a "fraudulent, deceptive, or manipulative act or practice," and authorizes the Commission, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts and practices. Exchange Act Section 15(c)(2), 15 U.S.C. 78*o*(c)(2). Rule 15c2–12 also was adopted pursuant to the Commission's authority under Exchange Act Section 2, 3, 10, 15, 15B, and 23; 15 U.S.C. 78b, 78c, 78j, 78*o*, 78*o*–4, 78q, and 78w.

[3] 17 CFR 240.15c2–12. Rule 15c2–12 was proposed for adoption in 1988, and adopted in 1989. *See* Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778 ("1988 Release"); Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("1989 Release"). Rule 15c2–12 requires an underwriter of municipal securities (1) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (3) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (4) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of the rules of the MSRB.

[4] The 1989 Release also stated that issuers are primarily responsible for the content of their disclosure documents, and may be held primarily liable under the federal securities laws for misleading disclosure. *See* 1989 Release at n. 84.

[5] Since September, 1993, other initiatives related to the municipal securities market have been taken. On April 7, 1994, the Commission approved changes to MSRB rule G–19 concerning suitability of recommendations, and rule G–8 concerning recordkeeping. Securities Exchange Act Release No. 33869 (April 7, 1994), 59 FR 17632. These changes are designed to ensure that dealers, before making recommendations to customers, take appropriate steps to determine that the transaction is suitable. Concurrently, the Commission approved MSRB rule G–37 relating to the linkage between political contributions and the municipal securities business. Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621. The rule seeks to end "pay to play" abuses in the municipal securities market by prohibiting dealers from conducting certain types of business with an issuer within two years after any contribution by the dealer or certain affiliated persons of the issuer who could influence the awarding of municipal securities business. On June 20, 1994, the MSRB filed with the Commission a proposal to amend MSRB rule G–14 concerning reports of sales or purchases, and procedures for reporting inter-dealer transactions. Securities Exchange Act Release No. 34458 (July 28, 1994), 59 FR 39803. The proposed rule change is a first step to increase transparency in the municipal securities market by collecting and disseminating information on interdealer transactions. On December 19, 1993, the Commission issued a release proposing for public comment amendments to the rule regulating money market funds, Rule 2a–7 under the Investment Company Act of 1940. Investment Company Act Release No. 19959 (Dec. 28, 1993), 58 FR 68585.

[6] By 1993, individual investors, including those holding through mutual funds and money market funds, held approximately 76% of municipal debt outstanding, as compared with 44% in 1983. *The Bond Buyer*, "Holders of Municipal Debt," (July 1, 1994) at 5.

[7] The municipal securities market is not the only market for debt securities that suffers from information inefficiencies. For that reason, the Commission also is exploring means to increase the amount of information concerning issuers of corporate debt securities. *See* Securities Exchange Act Release No. 34139 (June 7, 1994), 59 FR 29453.

information about municipal issuers and obligated persons is regularly disseminated, as it is in primary offerings, where, as a general matter, good disclosure practices exist. As one industry group testified, today "secondary market information is difficult to come by even for professional municipal analysts, to say nothing of retail investors."[8]

Notwithstanding voluntary industry initiatives to improve disclosure, particularly primary market disclosure, the *Staff Report* recommended that the Commission use its interpretive authority to provide guidance regarding the disclosure obligations of municipal securities participants under the antifraud provisions of the federal securities laws, and that the Commission amend Rule 15c2–12 to prohibit municipal securities dealers from recommending outstanding municipal securities unless the issuer has committed to make available ongoing information regarding its financial condition. In order to assist issuers, brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions, in March, 1994, the Commission published the *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others* ("Interpretive Release"),[9] which outlined its views with respect to the disclosure obligations of market participants under the antifraud provisions of the federal securities laws in connection with both primary and secondary market disclosure.

Concurrent with the publication of the Interpretive Release, the Commission published Securities Exchange Act Release No. 33742 ("Proposing Release"),[10] which requested comment on amendments to Rule 15c2–12 ("Proposed Amendments") designed to enhance the quality, timing, and dissemination of disclosure in the municipal securities market by placing certain requirements on brokers, dealers, and municipal securities dealers. In proposing the amendments, the Commission intended to further deter fraud by preventing the underwriting and recommendation of transactions in municipal securities about which little or no current information exists. Brokers, dealers, and municipal securities dealers serve as the link between the issuers whose securities they sell and the investors to whom they recommend securities. Investors, especially individual investors, place their reliance on these securities professionals for their recommendations of municipal securities.

The amendments to Rule 15c2–12 ensure that brokers, dealers, and municipal securities dealers will review the secondary market disclosure practices of issuers and other obligated persons at the time of an offering of municipal securities.[13] This scrutiny at the time of initial issuance of municipal securities will result in the dissemination of important information by issuers and other obligated persons throughout the term of the municipal securities. As a result of the amendments, brokers, dealers, and municipal securities dealers will be better able to satisfy their obligation under the federal securities laws to have a reasonable basis on which to recommend municipal securities, as well as their obligations under the rules of the MSRB.

The availability of secondary market disclosure to all municipal securities market participants will enable investors to better protect themselves from misrepresentation or other fraudulent activities by brokers, dealers, and municipal securities dealers. A lack of consistent secondary market disclosure impairs investors' ability to acquire information necessary to make intelligent, informed investment decisions, and thus, to protect themselves from fraud.

In the Proposing Release, comment was requested on each aspect of the Proposed Amendments, as well as on standards for recognition of nationally recognized municipal securities information repositories ("NRMSIRs"). In response to the request for comments, the Commission received over 390 comment letters representing over 475 groups and individuals. The commenters represented all types of participants in the municipal securities market, including issuers, underwriters, investors, counsel, analysts, financial advisers, banks, insurance providers, disclosure services, and the MSRB.[14] The comment letters presented a variety of thoughtful views on the issues raised by the Proposing Release.[15] The Commission has determined to adopt amendments to Rule 15c2–12, with certain modifications that are designed to address concerns expressed by commenters.[16] In addition, the suggestions of a group of industry participants that cooperated to assist the Commission in its efforts to improve disclosure in the municipal securities market have been valuable.[17]

Commenters across a broad range of market participants supported the goal of improved secondary market disclosure for the municipal securities market, but emphasized that flexibility is necessary, given the diversity that exists in the municipal securities market.[18] As adopted, the amendments

[8] Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee (October 7, 1993) at 5.

[9] Securities Act Release No. 7049 (March 9, 1994), 59 FR 12748.

[10] Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759. Also on March 9, the Commission published Securities Exchange Act Release No. 33743, which proposed the adoption of Rule 15c2–13. Proposed Rule 15c2–13 would have required brokers, dealers, and municipal securities dealers to disclose mark-up information in riskless principal transactions in municipal securities; and to disclose when a particular municipal security is not rated by a nationally recognized statistical rating organization ("NRSRO"). Due to the recent development of proposals by the MSRB and market participants to make pricing information available to investors, the Commission has determined to defer the riskless principal mark-up proposal for six months. In addition, the portion of proposed Rule 15c2–13 that would require disclosure if a municipal security is not rated by an NRSRO has been deferred, and will be withdrawn if the MSRB acts to adopt similar amendments to its confirmation rule, Rule G–15. *See* Securities Exchange Act Release No. 34962 (November 10, 1994).

[13] Participating Underwriters generally maintain a market in an issue of municipal securities in the period following an offering. Failure by a Participating Underwriter to receive assurances with respect to undertakings to provide secondary market disclosure will increase the difficulty of its formulation of a reasonable basis on which to recommend a municipal security during this period of secondary market trading.

[14] Among others, the Commission received 232 letters representing the views of 242 issuers and issuer associations; 52 letters representing the views of 57 brokers, dealers, and municipal securities dealers; and 8 letters representing the views of 8 investors and investor associations.

[15] The Commission has given consideration to the views of some commenters who questioned the Commission's authority to adopt the amendments to Rule 15c2–12. *See, e.g.*, Letter of ABA Business Law Section; Letter of Hawkins Delafield & Wood; Letter of NABL. The Commission believes that it has ample authority to adopt the amendments.

[16] The comment letters and a summary of the comment letters prepared by Commission staff are contained in Public File No. S7–5–94. *See also* Public File No. S7–4–94.

[17] *See* Joint Response to the Securities Exchange Commission on Releases Concerning Municipal Securities Market Disclosure prepared by American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, Public Securities Association ("Joint Response").

[18] *See, e.g.*, Joint Response; Letter of Chapman and Cutler; Letter of Florida Division of Bond Finance of the State Board of Administration; Letter of J.P. Morgan Securities, Inc.; Letter of National

Continued

to Rule 15c2–12 will further that goal by prohibiting underwritings unless there are commitments to provide ongoing disclosure, while, at the same time, providing issuers with significant flexibility to determine the appropriate nature of that disclosure. The amendments retain the requirement that a Participating Underwriter ascertain that an issuer or obligated person has undertaken to provide secondary market disclosure, including notices of material events, to information repositories, but rely on the parties to the transaction to establish who will provide secondary market disclosure, and what information is material to an understanding of the security being offered.

The amendments build upon and reinforce current market practices that have provided, as a general matter, good quality disclosure in official statements, and extend those practices to the secondary market. As is currently the practice, under the amendments, the participants in an underwriting would continue to determine which persons are material to an understanding of the Offering. Information concerning those persons would be included in the final official statement. Financial information and operating data that is material to an offering at the outset generally remains material throughout the life of the securities. Under the amendments, that information would be provided on an annual basis. Put simply, the amendments reflect the belief that purchasers in the secondary market need the same level of financial information and operating data in making investment decisions as purchasers in the underwritten offering.

The Proposed Amendments would have prohibited a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security, unless it had reviewed the annual and event information provided pursuant to the undertaking. Commenters anticipated that such a prohibition would have a considerable negative impact on secondary market liquidity. Furthermore, brokers, dealers, and municipal securities dealers considered the proposed recommendation prohibition to be problematic from a compliance perspective. The Commission has modified this provision to require instead that brokers, dealers, and municipal securities dealers recommending municipal securities in the secondary market have procedures to obtain material event notices. Because under existing law brokers, dealers, and municipal securities dealers are required to use information disseminated into the marketplace in forming a reasonable basis for recommending securities to investors, the rule does not impose mechanical review requirements on a trade-by-trade basis.

The amendments contain an exemption to minimize the effect on small issuers. Offerings in which neither the issuer nor any obligor is obligated with respect to more than $10 million dollars in municipal securities outstanding following an offering will be exempt from the amendments, on the condition that there is a limited undertaking to provide upon request, or annually to a state information depository, at least the financial information or operating data they customarily prepare, and that is publicly available. In addition, the undertaking must meet the amendment's requirement regarding notices of material events.

II. Description of Amendments To Rule 15c2–12

A. Amendments With Respect to the Underwriting of Municipal Securities

Under the amendments to Rule 15c2–12, a broker, dealer, or municipal securities dealer ("Participating Underwriter") [19] will be prohibited, subject to certain exemptions, from purchasing or selling municipal securities in connection with a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more ("Offering"),[20] unless the Participating Underwriter has made certain determinations.[21] Specifically, the Participating Underwriter must reasonably determine that an issuer of municipal securities or an obligated person, either individually or in combination with other issuers of such municipal securities or other obligated persons,[22] has undertaken in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent, certain annual financial information and event notices to various information repositories.[23]

The "reasonable determination" required by the amendments to Rule 15c2–12 must be made by the Participating Underwriter prior to its purchasing or selling municipal securities in connection with an Offering. A Participating Underwriter would, therefore, need to receive assurances from the issuer or obligated persons that such undertakings would be made before agreeing to act as an underwriter. A dealer could look to provisions in the underwriting agreement or bond purchase agreement that describe the undertakings for the benefit of bondholders made elsewhere, such as in a trust indenture, bond resolution, or separate written agreement.[24] In a competitively bid offering, such assurances also might be found in a notice of sale. Of course, representations concerning commitments to provide secondary market disclosure, like any other key representations by an issuer, are subject to specific verification, such that a Participating Underwriter has a reasonable basis to believe that such representations are true and accurate. Thus, investigation of an issuer's or obligated person's undertakings to provide secondary market disclosure would be an element of the Participating Underwriter's professional review of offering documents.[25]

Because the amendments prohibit Participating Underwriters from purchasing or selling securities in the absence of undertakings in a written agreement or contract, such agreement or contract would have to be in place at the time the issuer delivers the securities to the Participating Underwriter.[26] As discussed below, in conditioning the closing of an Offering on the existence of an agreement or contract, this provision of the amendments permits flexibility as to where undertakings for continuing disclosure are memorialized.[27]

Association of Bond Lawyers ("NABL"); Letter of Orrick, Herrington & Sutcliffe ("Orrick Herrington"); Letter of Public Securities Association ("PSA").

[19] *See* Rule 15c2–12(a).

[20] The amendments also include an exemption for small and infrequent issuers. *See* Section II.D.1., *infra*.

[21] Rule 15c2–12(b)(5)(i).

[22] These concepts are discussed in Section II.A.1.b., *infra*.

[23] Information repositories are discussed in Section II.C., *infra*.

[24] *See* Letter of Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch").

[25] As noted in the 1988 Release, the obligations of managing underwriters and underwriters participating in an offering differ. An underwriter participating in an offering need not duplicate the efforts of the managing underwriter, but must satisfy itself that the managing underwriter reviewed the accuracy of the information in the official statement in a professional manner and therefore had a reasonable basis for its recommendation. Underwriters participating in offerings, however, have a duty to notify the managing underwriter of any factors that suggest inaccuracies in disclosure, or signal the need for additional investigation. *See* 1988 Release at n. 87.

[26] *See* Letter of Kutak Rock; Letter of Section of Urban, State and Local Government Law, American Bar Association ("ABA Urban Law Section"); Letter of Colorado Municipal Bond Supervisory Board.

[27] In contrast to the requirement in Rule 15c2–12(b)(5) that Participating Underwriters reasonably

The amendments to the definition of final official statement will affect the obligations of Participating Underwriters under Rule 15c2–12. Rule 15c2–12(b)(1) requires that a Participating Underwriter, prior to bidding for, purchasing, offering, or selling municipal securities, obtain and review a DFOS.[28] The Commission expects that Participating Underwriters will review the DFOS with a view to ascertaining that it contains information satisfying the definition of final official statement in Rule 15c2–12.[29] The Commission further expects that the quality of disclosure in the DFOS will improve in a manner that is commensurate with the changes in final official statement disclosure.[30]

Rule 15c2–12(b)(2) requires, for all except competitively bid offerings, from the time a Participating Underwriter has reached an understanding with an issuer of municipal securities that it will act as a Participating Underwriter, until the final official statement is available, that the Participating Underwriter send, to any potential customer, no later than the next business day, a copy of the most recent POS, if any. The Commission expects that the Participating Underwriters' obligations with respect to dissemination of the POS will not change.

1. Determining the Required Scope of the Undertaking to Provide Secondary Market Disclosure

Under the amendments as adopted, the financial information and operational data to be provided on an annual basis pursuant to the undertaking will mirror the financial information and operating data contained in the final official statement with respect to both the issuers and obligated persons that will be the subject of the ongoing disclosure, and the type of information provided. The amendments govern the core financial and operational data to be provided. It does not address the textual disclosure typically provided in annual reports, leaving the scope of that disclosure to market practice.[31] To clarify the intended quantitative focus of the rule, as adopted, the rule uses the term "financial information and operating data."

a. *The Starting Point—Definition of Final Official Statement*—(1) *Information Concerning Persons Material to an Evaluation of the Offering*. The Proposed Amendments would have revised the definition of final official statement to require that financial and operating information, including audited annual financial statements, regarding the issuer and any significant obligor be included in order to provide a fair presentation of the issuer's and significant obligor's financial condition, results of operations, and cash flow.

Commenters objected to various aspects of the proposed definition, including the general requirement that financial and operating information be presented in the final official statement.[32] Commenters also objected that the use of the term "the issuer," in specifying whose financial information should be included in the final official statement, failed to take into account a variety of situations in which the governmental issuer does not have any repayment obligations on the municipal securities (as with conduit issuers), as well as other situations (such as revenue bonds) in which the payments will be derived from entities, enterprises, funds and accounts that do not prepare separate financial statements. Some commenters took the position that in certain instances, inclusion of the financial statements of the general municipal issuer of which the enterprise is a part may be misleading.[33]

In view of these comments, the definition of final official statement has been revised to require that financial information and operating data be provided for those persons, entities, enterprises, funds, and accounts that are material to an evaluation of the offering.[34] Thus, the definition eliminates the reference to "the" issuer. In addition, the definition no longer requires that the official statement provide information about specific "significant obligors." It leaves to the parties (including the issuer and Participating Underwriters) the determination of whose financial information is material to the offering (including, without limitation, the credit supporting the securities being offered).

The definition does not set its own form and content requirements on the financial information and operating data to be included; in particular, the proposed requirement for audited financial statements has not been adopted. Instead, it provides the flexibility that many commenters asserted is necessary in determining the content and scope of the disclosed financial information and operating data, given the diversity among types of issuers, types of issues, and sources of repayment.[35]

The fact that the amendments rely on the final official statement to set the standard for ongoing disclosure should not serve as an incentive for issuers to reduce existing disclosure practices in the preparation of the final official

determine that issuers or obligated persons have undertaken to provide secondary market disclosure prior to the time they "purchase or sell" municipal securities, Rule 15c2–12(b)(1) requires Participating Underwriters to obtain and review an official statement deemed final by the issuer ("DFOS") prior to the time they "bid for, purchase, offer, or sell" securities. Thus, under Rule 15c2–12(b)(1), in a competitive underwriting, a Participating Underwriter must obtain and review the DFOS prior to placing a bid on an issue of municipal securities. Because the term "offer" encompasses the distribution of a preliminary official statement, as well as oral solicitations of indications of interest, in a negotiated underwriting, a Participating Underwriter is required to obtain and review the DFOS prior to the time it distributes the preliminary official statement to potential investors. If no offers are made, the Participating Underwriter is required to obtain and review the DFOS by the earlier of the time it agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds. *See* Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990); Interpretive Release at Section III.C.6.

[28] Information regarding the offering price, interest rate, selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriters, may be omitted from the official statement reviewed by the Participating Underwriter for purposes of Rule 15c2–12(b)(1).

[29] Whether information is in fact known or not reasonably ascertainable at the time the Participating Underwriter must obtain and review the DFOS pursuant to the rule is best determined in the context of each offering by the issuer, the Participating Underwriter, and their respective counsel. *See* Public Securities Association (May 29, 1992)

[30] As a practical matter, the DFOS and the preliminary official statement ("POS") are often the same document. *See* Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990).

[31] *See* Association of Local Housing Finance Agencies, *Guidelines for Information Disclosure to the Secondary Market* (1992); Government Finance Officers Association, *Disclosure Guidelines for State and Local Government Securities* (Jan. 1991); Healthcare Financial Management Association, Principles and Practices Board, *Statement Number 18—Public Disclosure of Financial and Operating Information by Healthcare Providers* (May 1994); National Council of State Housing Agencies, *Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds* (1989) and *Multi-family Disclosure Format* (1991); National Federation of Municipal Analysts, *Disclosure Handbook for Municipal Securities 1992 Update* (Nov. 1992).

[32] *See, e.g.*, Letter of Indiana Bond Bank; Letter of Kutak Rock; Letter of NABL; Letter of Texas Public Finance Authority; Letter of Goldman Sachs & Co. ("Goldman Sachs").

[33] *See, e.g.*, Letter of Department of Community Trade and Economic Development, State of Washington; Letter of American Public Power Association ("APPA"); Letter of Municipal Treasurer's Association; Letter of Orrick Herrington.

[34] *See* Rule 15c2–12(f)(3).

[35] *See, e.g.*, Letter of Association of Local Housing Financing Agencies ("ALHFA"); Letter of Treasurer, State of Connecticut Office of the Treasurer ("Treasurer of the State of Connecticut"); Letter of Council of Development Finance Agencies ("CDFA"); Joint Response; Letter of Securities Industry Association ("SIA"); Letter of Morgan Stanley & Co., Inc. ("Morgan Stanley").

statement. Market discipline and regulatory requirements should ensure that those practices continue at current or improved levels. While issuers remain primarily responsible for the content and accuracy of their disclosures,[36] as noted, Participating Underwriters must review the DFOS in a manner consistent with their obligations.

As the Commission recognized in the Interpretive Release,[37] the extensive voluntary guidelines issued by the Government Finance Officers' Association, and the industry specific guidelines published by industry groups such as the National Federation of Municipal Analysts, are followed widely in the preparation of official statements.[38] The Commission anticipates that such sound practices will continue and develop beyond that mandated by the amendments. Although those guidelines are not mandatory, the Commission encourages market participants to continue to refer to those voluntary guidelines and the Commission's Interpretive Release in preparing disclosure documents. In addition, as noted in the Interpretive Release,[39] final official statements are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading.

(2) *Use of cross references to publicly available information*. The Proposing Release requested comment on the appropriateness of satisfying disclosure needs through a reference to other externally prepared and located documents. In response, a number of commenters stated that the concept of incorporation of information should be explicitly included in the rule,[40] and that the ability to incorporate information should not be conditioned on a minimum dollar amount of securities in the hands of the public—commonly known as "public float."[41] Some commenters also suggested that any limitation of this practice to "seasoned issuers" should include all investment grade issuers.[42] Some commenters further noted that the final official statement should not have to set forth information that has been filed with the Commission in accordance with its periodic reporting requirements.[43] The commenters suggested one significant prerequisite for permitting cross referencing—the availability of the information in some public repository.[44]

The definition of final official statement has been revised to make explicit[45] that a final official statement may include financial information and operating data either by setting forth the information in the document or set of documents composing the final official statement, or by including a specific reference to documents already prepared and previously made publicly available.[46] For purposes of the amendments, documents will be considered to be publicly available if they have been submitted to each NRMSIR and to the appropriate state information depository or, if the information concerns a reporting company, filed with the Commission. If the document is a final official statement, it must be available from the MSRB.

If cross referencing is used, for purposes of determining the appropriate scope of the ongoing information undertaking, the final official statement will be deemed to include all information and documents that have been cross referenced.[47] The amendment does not place limitations on the type of issuer that may use cross referencing. This approach is consistent with the goal of making the repositories the principal source of information concerning municipal securities. Once received by a repository, the referenced information should be readily available regardless of the nature of the issuer.

As commenters noted, permitting cross referencing to other externally prepared and available information should result in official statements that are clear and concise, yet provide information material to the Offering.[48] Moreover, the use of cross referencing also should ease some expressed apprehension about the ability of some issuers to obtain information about parties not within their control, to the extent that information about these parties is made available to the repositories or, if a reporting company, filed with the Commission.[49]

(3) *Description of information undertakings*. The definition of final official statement also has been changed from the Proposed Amendments to include a requirement that the undertakings provided pursuant to the rule be described in the final official statement.[50] As the Commission recognized in the Interpretive Release[51] and a number of commenters echoed,[52] it is important for investors and the market to know the scope of any ongoing disclosure. By including a description of the undertaking in the final official statement, market participants will know the identity of the entities about which information will be provided, and the type of information to be provided. By reviewing the final official statement, investors in the secondary market will be able to ascertain the scope of that undertaking and whether it has been satisfied.

Critical to any evaluation of a covenant is the likelihood that the issuer or obligated person will abide by the undertaking. The definition of final official statement thus has been

[36] *See* 1989 Release.

[37] Interpretive Release at Section III.B. The Interpretive Release is cited in the Preliminary Note to Rule 15c2–12 as a source of guidance as to the disclosure obligations of issuers of municipal securities, as well as the role of brokers, dealers, and municipal securities dealers.

[38] *See* note 31, *supra*.

[39] *See* Interpretive Release at Section III.A.

[40] *See* Joint Response.

[41] *See* Letter of ABA Urban Law Section; Letter of Bose McKinney & Evans; Joint Response; Letter of Mudge Rose Guthrie Alexander & Ferdon ("Mudge Rose"); Letter of Dormitory Authority of the State of New York ("New York Dormitory Authority").

[42] *See* Letter of Mudge Rose; Letter of New York Dormitory Authority.

[43] *See* Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Texas Public Finance Authority.

[44] *See, e.g.*, Letter of Bose McKinney & Evans; Joint Response. One commenter also stated that if cross referencing was permitted, there should be a delay between the distribution of the official statement and the offering. The delay would enable potential purchasers and others to obtain any materials that were referenced in the official statement and make an informed investment decision. *See* Letter of Prudential Investment Corp.

[45] *See* 1989 Release (discussing the definition of "final official statement" in Rule 15c2–12 as originally adopted, and stating that the definition recognizes that the issuer's final official statement may be composed of one or more documents).

[46] Rule 15c2–12(f)(3). To avoid confusion with the technical aspects of incorporation by reference for registrants under the Commission's registration rules, the amended rule does not use that term.

At least two states, New York and Texas, have prepared a standard disclosure document for state information.

[47] Participating Underwriters and other market participants must keep in mind their obligations under the rule with respect to the DFOS and final official statement, and under the antifraud provisions of the federal securities laws. To the extent that cross references are used, the DFOS should be disseminated in sufficient time for review by Participating Underwriters, and the POS should be made available in time to enable prospective purchasers to make informed investment decisions based upon the referenced materials. *See* Interpretive Release at Section III.C.6.

[48] *See, e.g.*, Letter of New York Dormitory Authority; Letter of the Treasurer of the State of Connecticut.

[49] *See, e.g.*, Letter of Fieldman, Rolapp & Associates; Letter of State of Florida, Office of Auditor General; Letter of San Francisco International Airport; Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

[50] Rule 15c2–12(f)(3).

[51] *See* Interpretive Release at Section III.C.4.

[52] *See, e.g.*, Letter of Chemical Securities, Inc. ("Chemical Securities"); Letter of Ferris Baker Watts; Letter of National Federation of Municipal Analysts ("NFMA").

modified to require disclosure of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous informational undertakings called for by the amendments.[53] This information is important to the market, and should, therefore, be disclosed in the final official statement. The requirement should provide an additional incentive for issuers and obligated persons to comply with their undertakings to provide secondary market disclosure, and will ensure that Participating Underwriters and others are able to assess the reliability of disclosure representations.[54]

The amendments do not prohibit Participating Underwriters from underwriting an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure. However, if a failure to comply with such previous undertakings has not been remedied as of the start of the Offering, or if the party has a history of persistent and material breaches, it is doubtful whether a Participating Underwriter could form a reasonable basis for relying on the accuracy of the issuer's or obligated person's ongoing disclosure representations.

b. *Entities about which information must be provided to the secondary market.* It is critical that current financial information and operating data is provided to the secondary market about the persons that would be important to investors in evaluating the security. The Proposed Amendments would have required the Participating Underwriter to determine that the issuer had committed to provide, at least annually, current financial information concerning the issuer of the municipal securities and any significant obligor.[55] The identity of persons about which information should be provided to the secondary market was the subject of a substantial number of comment letters.[56] As with the proposed definition of final official statement, a large number of commenters expressed particular concern about the provision of information on a continuing basis for conduit issuers who have no ongoing liability for repayment of municipal securities.[57] There also were a significant number of comments received critiquing the concept of significant obligor.[58]

Under the amendments as revised, the identity of the persons for which information must be provided on an annual basis is determined by the information included in the final official statement. If the final official statement includes financial information or operating data on a person, information about that person must continue to be provided to the secondary market if the person is committed by contract or other arrangement to support payment of the obligations on the municipal securities.[59] Thus, the obligation to provide ongoing information relates to those persons for which financial information or operating data is included in the final official statement *and* that have a contractual or other connection to repayment of the municipal obligations.

(1) *The obligated person concept.* The Proposed Amendments defined a significant obligor as "any person who, directly or indirectly, is the source of 20 percent or more of the cash flow servicing the obligations on the municipal security." The proposed definition generated a significant amount of comment, including concerns that it could be interpreted to include significant taxpayers and customers,[60] credit enhancers (including banks that are letter of credit providers and insurers providing bond insurance),[61] providers of guaranteed investment contracts,[62] as well as state and federal governments that provide revenue sharing, grant, state and local aid and other cofinancing arrangements.[63] Commenters raised technical concerns as to the appropriate percentage of repayment obligation necessary to trigger inclusion in the definition of significant obligor,[64] and when the percentages were to be measured.[65] Some commenters also expressed concern that, in the bond pool context, the definition of significant obligor may not have permitted sufficient flexibility in determining which obligors in a pool would be the subject of the requirement to provide information on an ongoing basis.[66]

Commenters suggested a number of modifications to the significant obligor concept. First, a number of commenters indicated that the definition of significant obligor should include a requirement that a contractual relationship exist between the obligor and the repayment of the obligation before a continuing information obligation is imposed.[67] Second, commenters recommended modifying the definition to include different percentages of cash flow, ranging from a low of no threshold to a high of 50% of cash flow.[68] Third, some commenters suggested replacing the entire definition of significant obligor with the concept of materiality, in which the issuer and the other offering participants would determine, on a continuing basis, whose information would be provided.[69]

---

[53] *See* Rule 15c2–12(f)(3).

[54] *See* Letter of PSA.

[55] Paragraph (b)(5)(i)(A) of the Proposed Amendments.

[56] *See, e.g.*, Letter of Fidelity Management and Research Company; Letter of First Albany Corporation; Letter of Maine Municipal Bond Bank; Letter of NABL; Letter of National Council of Health Facilities Finance Authorities ("NCHFFA"); Letter of Realvest Capital Corporation; Letter of South Carolina Economic Developers Association, Inc.

[57] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Gilmore & Bell, P.C. ("Gilmore & Bell"); Letter of New York State Housing Finance Agency, State of New York Mortgage Agency, New York State Medical Care Facilities Finance Agency ("New York State Housing Finance Agency"); Letter of Orrick Herrington.

[58] *See, e.g.*, Letter of Section of Business Law, American Bar Association ("ABA Business Law Section"); Letter of Treasurer of the State of California ("Treasurer of the State of California"); Letter of Goldman Sachs; Letter of IDS Financial Corporation; Joint Response; Letter of Kutak Rock; Letter of Morgan Stanley; Letter of National Association of State Treasurers ("NAST").

[59] Providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers. *See* Section II.A.1.b.(1). *infra*.

[60] *See, e.g.*, Letter of American Municipal Power—Ohio, Inc. ("AMP—Ohio"); Letter of Gilmore & Bell; Letter of Treasurer of the State of California.

[61] *See, e.g.*, Letter of Financial Guaranty Insurance Company ("FGIC"); Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Thacher Proffitt & Wood.

[62] *See, e.g.*, Letter of Kutak Rock.

[63] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of State of Washington, Office of the Treasurer.

[64] *See, e.g.*, Letter of APPA; Letter of George K. Baum & Co.; Letter of CDFA; Letter of Eaton Vance Management; Letter of NCHFFA.

[65] *See, e.g.*, Letter of ABA Business Law Section; Letter of Electricities, Inc.; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of Mudge Rose; Letter of San Francisco International Airport.

[66] *See, e.g.*, Letter of ABA Urban Law Section; Letter of A.G. Edwards & Sons, Inc.; Letter of Council of Infrastructure Financing Authorities ("CIFA"); Letter of Hawkins Delafield & Wood; Letter of Program Administration Services, Inc.

[67] *See, e.g.*, Letter of ABA Business Law Section; Letter of APPA; Letter of City of Everett, Washington; Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Merrill Lynch; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Orrick Herrington. Certain of these commenters noted that by including a contractual or similar relationship between the entity making payments and the financing, customers and taxpayers, having no connection to or responsibility in connection with the financing would not inadvertently be swept within the scope of the definition.

[68] *See, e.g.*, Letter of APPA; Letter of George K. Baum & Co.; Letter of City of Everett, Washington; Letter of IDS Financial Corporation; Letter of Standish, Ayer & Wood, Inc.

[69] *See, e.g.*, Letter of ABA Business Law Section; Letter of ALHFA; Letter of PSA.

As suggested by a number of commenters, the amendments eliminate the reference to significant obligor.[70] Instead, the amendments include a definition of "obligated person," which means a person (including an issuer of separate securities) that is committed by contract or other arrangement structured to support payment of all or part of the obligations on the municipal securities.[71] By including a nexus to the financing through a commitment that is structured to support the payment obligations, the amendments address concerns raised by many commenters that the term "source of cash flow" in the definition of significant obligor was overbroad and could encompass persons with no relationship to the financing.[72] The requirement for a contractual or other arrangement will assist Participating Underwriters in identifying the persons for which information should be provided pursuant to an undertaking.

Some commenters recommended that the commitment with respect to payment of the obligation on the securities consist of a contractual obligation to and enforceable by bondholders.[73] Instead, the definition includes a broader notion of a contract or arrangement that is structured to "support payment," without specifying that it run to bondholders. The definition is intended to include contracts or arrangements where payments are made either to bondholders, to issuers to be used to pay obligations on municipal securities, or through conduit structures.[74] Similarly, the reference to "obligations on municipal securities" is intended to be broad enough to cover debt obligations, lease payments and any other repayment obligation on or resulting from the municipal securities.

As was the case with the proposed significant obligor concept, the term "obligated persons" includes, but is broader than, the concept of issuers of separate securities under Rule 131 pursuant to the Securities Act of 1933 ("Securities Act")[75] and Exchange Act Rule 3b–5.[76] Also, in response to comments raised that the terms "issuer" or "significant obligor" do not sufficiently address financings in which the source of repayment is not a separate person or entity, but a dedicated revenue stream from a specified project, segregated tax revenues or other enterprise, fund or account,[77] the definition includes persons which are obligated generally, such as with full recourse to the person, or, in a more limited manner, such as through an enterprise, fund or account of such person, including a dedicated revenue stream. As noted above, the obligation to provide information must cover all such enterprises, funds or accounts, whether or not there is a separate entity. In such a case, the information undertaking could be provided by the governmental unit or financing authority of which the enterprise, fund or account is a part.[78] For example, a Participating Underwriter could accept an information undertaking from a state issuing bonds secured solely by funds collected under a special tax, to report financial information relating to the special tax; for issues supported both by contracts of assistance of separate authorities or funds in addition to the issuer's own revenues, undertakings from the separate authorities, as well as the issuer could be provided. Accordingly, although the definition of significant obligor has been eliminated, that modification does not reflect a change in the Commission's assessment of the importance of ongoing information concerning the ultimate sources of payment on the securities.

Unlike the significant obligor concept in the Proposed Amendments, there is no need to include a specified percentage of payment in the definition of obligated person, because the issuer and other participants will determine at the time of preparation of the final official statement which obligated persons are material to an Offering.[79] In making that materiality determination, the parties to a financing will evaluate the facts of the Offering.[80]

Determining the obligated persons in pooled financings requires more flexibility, because the composition of the pool may vary over time. Rather than identifying the specific persons for which information will be provided on a continuing basis, under the amendments, bond pools must describe in their official statements, and the undertaking, the objective criteria (presumably including percentage of payment support) they will apply consistently, both in the final official statement and on a continuing basis, in determining whether information concerning an obligated person will be provided.[81] The amendments permit, but do not require this approach for non-pooled issuers. The objective criteria approach ensures that financial information and operating data will be provided about those persons that, at the time of disclosure, meet the objective standards described in the undertakings. Obligated persons could commit to the issuer, at the time of initial participation in a pooled financing, through an undertaking to provide information when and if they

---

[70] *See, e.g.*, Letter of FGIC; Joint Response; Letter of NABL; Letter of PSA.

[71] *See* Rule 15c2–12(f)(10).

[72] *See, e.g.*, Letter of Bose McKinney & Evans; Letter of Mudge Rose; Letter of New York Dormitory Authority; Letter of Orrick Herrington.

[73] *See, e.g.*, Letter of Bose McKinney & Evans; Letter of Goldman Sachs; Letter of Indiana Bond Bank; Letter of Hawkins Delafield & Wood.

[74] For example, if all or a portion of a project financed by bonds is used by a party that has committed, by contract or other arrangement (written or oral) to pay for such use, and such payments support payment of debt service on the bonds (as structured at the time of issuance), continuing information on the party would be appropriate. Accordingly, parties that support debt service through payments under a lease, loan, installment sale agreement, or other contract relating to use of a project are included in the definition, regardless of whether the financing is a conduit arrangement (such as a non-recourse loan to a manufacturer to finance acquisition of a new facility or to a hospital to acquire equipment) or system or project financing (such as a lease to a particular carrier of a terminal in an airport system or sale of the output of a facility pursuant to a take-or-pay (or take-and-pay) contract). Major customers purchasing power from a municipal light department that, in turn, is under a take-or-pay contract with a joint action public power agency would not be included in the definition, although the municipal light department would likely be included in the definition. Similarly, major taxpayers in a municipal general obligation issue would not be included in the definition; however, an undertaking covering a developer that is the sole landowner in a development district assessment financing in which the future collection of assessments to service the borrowing is dependent upon the developer as part of the structure of the financing may be appropriate.

[75] 17 CFR 239.131.

[76] 17 CFR 240.3b-5

[77] *See, e.g.*, Letter of Fidelity Management and Research Company; Letter of Mudge Rose; Letter of NABL; Letter of Texas Public Finance Authority.

[78] *See* Rule 15c2–12(b)(5)(i).

[79] Under the revised amendments, the concerns of some commenters that the definition of significant obligor failed to take into account short term arrangements (*i.e.* the arrangements with persons providing cash flow were shorter than the term of the securities) is also alleviated in two ways. First, the issuer determines at the outset if an obligated person is material to the offering. Second, assuming an obligated person is included in the final official statement, the undertaking to continue to provide information on such obligated person may be terminated once it no longer has liability for any obligation on or relating to repayment of the municipal securities. *See* Rule 15c2–12(b)(5)(iii); Letter of APPA; Letter of Hawkins Delafield & Wood.

[80] Guidelines and practices that have developed in other contexts may be useful in analyzing both the materiality of an obligated person to the municipal financing and the appropriate level of disclosure relating to such obligated person. For example, in connection with securitization of non-recourse commercial mortgage loans, the 10 percent and 20 percent property assets concentration tests described in Staff Accounting Bulletins 71 and 71A are applied. These percentages are applied by analogy in other asset-backed financings.

[81] Although the amendments do not specify the scope of the objective criteria, the criteria description should be clear as to when and how they are applied.

satisfy that criteria. Obligated persons that no longer meet the objective criteria will no longer need to provide ongoing information. In order to ensure that the selection method is incorporated into the undertaking, the amendments require that Participating Underwriters reasonably determine that the undertakings identify those persons for which the information will be provided, either by name or by the objective criteria to be used to select such persons.[82]

Commenters were divided on whether providers of bond insurance, letters of credit, and other liquidity facilities, should be excluded from the definition of significant obligor.[83] The concept of "obligated person" encompasses these entities because they are committed, at least conditionally, to support payment of principal and interest obligations. Moreover, these persons normally are material to an understanding of the security, and, therefore, official statements should contain financial information concerning such persons either directly or by reference to publicly available materials. A number of commenters stated, however, that it would be inappropriate to put the onus on the issuer to provide information on such providers on an annual basis, particularly where that information is otherwise available to investors either upon request or in public reports that have been submitted to appropriate regulatory authorities.[84]

Commenters indicated a willingness by providers of bond insurance, letters of credit, and other liquidity facilities to deposit publicly available reports in a repository, or otherwise note where such reports may be easily obtained.[85] The issuer or other obligated person providing the undertaking may then refer to such reports in their annual financial information and indicate the location where any such current annual reports can be obtained. Based upon such representations, providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers.

The Commission encourages industry participants to work together to adopt appropriate disclosure practices, both with respect to information concerning the provider contained in primary offering materials and on an ongoing basis in the annual financial information. The Commission will monitor developments in this area regarding the nature and quality of information made available about credit enhancers and liquidity providers, and the manner in which information is made available to determine whether further steps are necessary to assure access to this important body of information.

(2) *Who must undertake.* A related question to whose information must be given is who must provide the information undertaking; the person providing the undertaking may not necessarily be the person about which the information relates. The Proposed Amendments would have required that the continuing information undertaking be provided by the issuer. A significant number of commenters raised concerns about which of potentially several persons that could be considered an issuer of municipal securities[86] would be expected to provide the undertaking and who would make that determination.[87] This was a particular concern in light of the potential liability of the issuer providing the undertaking for the provision and the content of information regarding other issuers and significant obligors—persons not necessarily under their control. Commenters made a number of suggestions to address these perceived ambiguities, including requiring that each issuer of a municipal security and each significant obligor undertake to provide the information only with respect to itself.[88]

In response to these concerns, and consistent with the general approach to affording underwriting participants significant flexibility, the undertaking provision has been revised to provide that the undertaking may be made by any issuer of the municipal securities being offered, or by any obligated person for which information is provided in the final official statement. An issuer of a municipal security may provide the undertaking, regardless of whether it is obligated on the municipal security. In addition, obligated persons may provide the undertaking regardless of whether they are deemed an issuer of municipal securities. These obligated persons may be the main, if not the only, credit source for repayment of the obligations on the municipal securities. This approach should allow the governmental issuer to shift to the obligated person the responsibility to provide information on a continuing basis.

Thus, a Participating Underwriter need only reasonably determine that an issuer of municipal securities or an obligated person for which financial information or operating data is presented in the final official statement has agreed to provide the information called for by the rule; it will not be necessary to obtain an undertaking from all possible issuers and obligated persons. Moreover, to respond to the expressed concern that separate undertakings should be permitted, the amendments have been revised to recognize that undertakings may be provided in combination with other issuers and other obligated persons. In all cases, however, the undertakings, either individually or collectively, must constitute a commitment to provide information with respect to all the persons about which information must be provided on an annual basis.

The amendments have been revised to clarify that dissemination

---

[82] *See* Rule 15c2–12(b)(5)(ii).

[83] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Blackwell Industrial Authority, Blackwell, Oklahoma; Letter of Davis Polk & Wardwell; Letter of IDS Financial Corporation; Letter of Kutak Rock; Letter of Oregon Economic Development Department; Letter of Realvest Capital Corporation; Letter of Thacher Proffitt & Wood. Some commenters also were concerned as to whether the definition would encompass providers of guaranteed investment contracts and other investments. *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock, on behalf of AMBAC Indemnity Corporation, Capital Markets Assurance Corporation, Capital Reinsurance Company, Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance, Inc., and Municipal Bond Investors Assurance Corporation ("Kutak Rock on behalf of Financial Guaranty Insurers"). A functional approach determines whether providers of investments should provide ongoing information. For example, if the proceeds of an Offering are invested in guaranteed investment contracts ("GICs"), and the income from the GICs is the predominant source of revenue to repay the obligations on the securities, information about the provider may be material to the Offering, including on an ongoing basis. If, however, other sources of revenue are committed to support payment of the obligations, the relative importance of the provider of the GIC to investors may be diminished.

[84] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Smith, Gambrell & Russell; Letter of Texas Water Development Board. Some commenters noted difficulty in obtaining information from credit enhancers. *See* Letter of Association of Bay Area Governments; Letter of New York State Housing Finance Agency; Letter of State of Washington, Office of the Treasurer.

[85] *See, e.g.*, Memorandum of August 10, 1994 Meeting with Davis, Polk and Wardwell and Various Banks; Letter of Kutak Rock on Behalf of Financial Guaranty Insurers. One commenter recommended that bond insurers and banks providing letters of credit, who are not subject to periodic reporting requirements of the federal securities laws, send publicly available reports to the repositories. *See* Letter of ABA Urban Law Section.

[86] The term "issuer of municipal securities," as defined in Rule 15c2–12, includes issuers of separate securities as well.

[87] *See, e.g.*, Letter of ALHFA; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of National State Auditors Association; Letter of the Treasurer of the State of North Carolina.

[88] *See, e.g.*, Letter of ABA Urban Law Section; Letter of ALHFA; Letter of Kutak Rock; Letter of NABL.

responsibilities may be delegated to designated agents or to indenture trustees. As commenters pointed out, there are circumstances in which third parties may be effective in assisting issuers and obligated persons in disseminating the information.[89] Moreover, indenture trustees have expressed concerns about being considered "designated agents" in performing any dissemination role, based on the scope of, and standards affecting, their responsibilities as indenture trustees.[90] The language has been revised in response to clarify that, in addition to designated agents, issuers or obligated persons may contractually empower indenture trustees to disseminate information that an issuer or obligated person has agreed to provide. The parties may authorize an indenture trustee to provide certain information through specific instruction or on its own initiative upon becoming aware of particular facts.

c. *Scope of financial information and operating data to be provided on an annual basis*—(1) *Definition of annual financial information.* The amendments provide a definition of the term "annual financial information," [91] a concept that was used, without definition, in the Proposed Amendments. The definition of annual financial information specifies both the timing of the information—that is, once a year—and, by referring to the final official statement, the type of financial information and operating data that is to be provided to the repositories. If financial information or operating data concerning an obligated person (or category of obligated persons in the case of financings using the objective criteria approach) is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data. For example, if anticipated cash flow information is provided in the final official statement for a revenue bond financing, cash flow data reflecting actual operations must continue to be provided on an annual basis. Only the annual financial information called for by the undertakings need be sent to the repositories; other types of financial information and reports that may be prepared by the issuer or obligated persons are not subject to the rule's dissemination provisions.

Many commenters addressed the issue of whether the rule should specify form and content of the information that should be provided on an annual basis, as well as for event specific information.[92] Some commenters argued that the rule should include specified formats for information to be provided, including financial statements and certain industry reporting formats,[93] while other commenters contended that no form or content should be specified and that the parties should be permitted to make determinations based on materiality alone.[94] As discussed below, the flexibility afforded by the concept of annual financial information addresses these concerns by providing a minimum standard for ongoing disclosure, but allowing the parties to define that standard with respect to each Offering of municipal securities.

(2) *Financial information.* The proposal to mandate audited financial statements produced considerable comment. As with the proposed definition of final official statement, commenters expressed concern with the availability of audited financial statements on an annual basis, as well as the relevance of financial statements for certain types of financings.

Some commenters indicated that some municipalities were not required by law to have independently audited financial statements, and any such requirement would impose a significant new expense.[95] A number of commenters also expressed doubt as to whether audited financial information could be delivered on an annual basis, because audits may not be completed for a number of years following the close of the fiscal year.[96] Commenters noted that in some cases, financial statements for certain types of entities were audited every year, and in other cases every 2–3 years.[97] Therefore, some of these commenters argued that the requirement for annual audited financial statements would have an adverse impact on an issuer's ability to access the public securities markets or increase its costs of financing.[98]

A number of commenters also raised concerns regarding the availability of full financial statements for certain issuers, whether or not audited.[99] As examples, commenters noted that some issuing entities do not have their own financial statements and may be included in the financial statements of a larger issuer or entity.[100] Commenters from two states indicated that governmental units of the states may be encompassed in the state's comprehensive annual financial report and that there may be only supplemental schedules that described the governmental units.[101]

Some commenters raised the point that financial statements of a general governmental unit may not necessarily be relevant in certain project and structured financings.[102] As an example, one commenter noted that in some asset backed financings, information about the governmental issuer may be relevant only with respect to its experience in managing programs of loan pools.[103]

Commenters proposed a number of alternatives to the requirement to provide annual audited financial statements. Among the alternatives was a suggestion that financial statements be required in the form customarily prepared by the issuer promptly upon becoming available and that audited financial statements be provided to the extent available.[104] Other suggestions included limiting the requirement to those entities required by state or federal law to have audited financial statements.[105]

[89] *See, e.g.*, Letter of Bond Investors Association; Letter of PSA; Letter of Texas Public Finance Authority.

[90] *See, e.g.*, Letter of Bank One Corporation; Letter of Reliance Trust Company; Letter of State Street Bank and Trust Company.

[91] Rule 15c2–12(f)(9).

[92] *See, e.g.*, Letter of Dean Witter Reynolds, Inc. ("Dean Witter"); Letter of National League of Cities; Letter of NFMA; Joint Response; Letter of PSA; Letter of Tillinghast, Collins & Graham; Letter of the Treasurer of the State of Connecticut.

[93] *See, e.g.*, Letter of Dain Bosworth, Inc.; Letter of First Albany Corporation; Letter of MSRB; Letter of NFMA; Letter of Standish, Ayer & Wood, Inc.

[94] *See, e.g.*, Letter of CDFA; Letter of Chapman and Cutler; Letter of CIFA; Joint Response; Letter of H.M. Quackenbush; Letter of NABL.

[95] *See, e.g.* Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

[96] *See, e.g.*, Letter of City of Barling; Letter of Dain Bosworth, Inc.; Letter of Friday, Eldridge & Clark.

[97] *See, e.g.*, Letter of AMP—Ohio; Letter of State of Indiana, State Board of Accounts; Letter of State of Montana, Department of Natural Resources and Conservation; Letter of Washington Finance Officers Association.

[98] *See, e.g.*, Letter of AMP—Ohio; Letter of Washington Finance Officers Association.

[99] *See, e.g.*, Letter of ABA Business Law Section; Letter of Florida Division of Bond Finance; Letter of Gust & Rosenfeld; Letter of Office of the State Auditor, Texas ("Texas Office of the State Auditor").

[100] *See, e.g.*, Letter of Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

[101] *See, e.g.*, Letter of the Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

[102] *See, e.g.*, Letter of ABA Urban Law Section; Letter of APPA; Letter of Goldman Sachs; Letter of Gust & Rosenfeld; Letter of The Hospital & Higher Education Facilities Authority of Philadelphia; Letter of Morgan Stanley; Letter of NABL; Letter of New York State Housing Finance Agency.

[103] *See* Letter of ABA Urban Law Section.

[104] *See, e.g.*, Letter of ABA Business Law Section; Letter of Association of Bay Area Governments; Letter of North East Independent School District; Letter of PSA; Letter of Washington Finance Officers Association.

[105] *See, e.g.*, Letter of the Treasurer of the State of North Carolina; Letter of Washington Finance Officers Association.

In view of the comments received, the amendments do not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments continue to require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. While it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses, it is possible that in the case of dedicated revenue streams and certain types of structured financings, other types of special purpose financial statements, project operating statements or reports may be used to reflect the financial position of the credit source for the financing. However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories.[106] Thus, as suggested by a number of commenters, the undertaking must include audited financial statements only in those cases where they otherwise are prepared.

The amendments adopt the proposed requirement that the undertaking specify the accounting principles pursuant to which the financial information provided as part of the annual financial information will be prepared.[107] As discussed in the Proposing Release, it is important that financial information be prepared on a consistent basis to enable market participants to evaluate results and perform year to year comparisons.[108] The undertaking also must specify whether audited financial statements will be provided as part of the annual financial information.[109]

The amendments do not establish a standardized format for presentation of financial information, or any specification of the content of the information, other than by reference to the final official statement. The annual financial information may be presented through any disclosure document or set of documents, whatever their form or principal purpose, that include the necessary information. The amendments, as adopted, contemplate that sequential final official statements prepared by frequent issuers may meet the standards of the rule. As in the case of final official statements, annual financial information submitted to a repository also may reference other information already submitted to repositories or the MSRB, or filed with the Commission.[110]

(3) *Operating data.* The Proposed Amendments[111] would have required that the undertaking call for pertinent operating information, and that the parties specify the pertinent operating information to be provided on an annual basis. The basic concern of commenters regarding this provision, in addition to issues of specification of form and content discussed above, was that the use of the term "pertinent" did not provide sufficient guidance as to who would determine what was pertinent and what independent obligations Participating Underwriters would have with respect to such evaluation.[112]

The amendments have been modified to respond to these comments. The phrase "pertinent" has been deleted from the reference to operating information and the word "data" is used to emphasize the intended quantitative nature of the information. Operating data is included as a subset of annual financial information, and the operating data to be provided annually also is determined by reference to the type of operating data presented in the final official statement. Thus, the parties will determine at the outset, presumably with the assistance of applicable industry guidelines, what operating data will be provided both initially and on an ongoing basis. For example, in a conduit health care financing, under current industry practice, an official statement typically provides information relating to the obligated party—the hospital—in an appendix. In addition to a discussion describing the hospital, its administration and management, economic base and service area, and capital plan, operating statistics such as bed utilization, admissions and type, patient days, and payor utilization often is provided. Under the amendments, in this type of transaction, parties at the outset of a transaction will determine which operating data will be included in the hospital appendix; such information, in turn, will be the type of "operating data" to be provided annually.

Some commenters expressed concern that the Proposed Amendments were not sufficiently flexible to permit parties to address changing conditions because the undertaking would have to describe the financial and pertinent operating information to be provided in the future.[113] Nonetheless, the requirement that the undertaking specify in reasonable detail the type of data that will be provided on an ongoing basis, including the identity of the persons (or category of persons) about which the information will relate has been retained. As is the case with financial information, the intent of the amendments is to give investors and market participants the ability to evaluate the security through comparisons of the quantitative operating data provided. Contrary to the suggestion of some commenters, the undertaking would be meaningless if issuers and obligated persons could unilaterally determine that certain types of information were no longer necessary or meaningful to investors.

Because the amendments require that the undertaking specify only the general type of information to be supplied, there should be sufficient flexibility to accommodate subsequent developments that may require adjustments in the financial information and operating data that should be provided annually. Of course, nothing in the undertaking will prevent a party from providing additional information, particularly where such disclosure may be necessary to avoid liability under the antifraud provisions of the federal securities laws. Similarly, the amendments make specific provision for adjusting the persons about which information is provided. As required in the case of pooled financings, parties may identify the persons covered by reference to objective selection criteria that will be applied on a consistent basis between the offering statements and with regard to annual financial information. Moreover, the party providing the undertaking need not continue to provide information concerning persons that are no longer obligated persons with respect to the municipal securities.

A new provision has been added to the amendments which permits the written agreement or contract to have a

[106] *See* Rule 15c2–12(b)(5)(i)(B).

[107] *See* Rule 15c2–12(b)(5)(ii)(B).

[108] *See* Proposing Release. A number of commenters responded to the request for comment on specification of the use of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS"). *See, e.g.*, Letter of Comptroller of the State of California; Letter of Government Accounting Standards Board ("GASB"); Letter of NAST; Letter of National State Auditors Association; Letter of Prudential Investment Corp. The amendments as adopted do not mandate the use of either GAAP or GAAS.

[109] *See* Rule 15c2–12(b)(5)(ii)(B).

[110] Of course, any required information must be the subject of an undertaking, and if the information cross referenced has not been submitted to a repository or the MSRB, or filed with the Commission, the undertaking will not have been complied with.

[111] Paragraph (b)(5)(i)(A) of the Proposed Amendments.

[112] *See, e.g.*, Letter of APPA; Letter of Fidelity Management and Research Company; Letter of Hawkins Delafield & Wood.

[113] *See, e.g.*, Letter of Chapman and Cutler; Joint Response; Letter of Kutak Rock.

termination provision with respect to any obligated person that is no longer directly or indirectly liable for repayment of any of the obligations on the municipal securities.[114] Once an obligated person no longer has any liability for repayment of the municipal securities, whether through termination or expiration of its commitment to support payment, or as a result of a defeasance of the municipal securities with no remaining liability, then the obligation to provide annual financial information and notices of events may terminate.

2. Notice of Material Events

Commenters generally agreed that issuers and obligors should be subject to an undertaking to provide event information to the market.[115] Brokers, dealers and municipal securities dealers supported these provisions of the Proposed Amendments, because the use of a list provides guidance as to what events should be covered.[116] Other commenters, however, felt that the list should be deleted from the rule and that the concept of materiality should be relied upon to determine what events should be the subject of notices.[117] Some commenters believed that the list of eleven events should be expanded to include a provision that would cover any other event that might reasonably be expected to have a material adverse effect on the holders of the bonds.[118]

The list of eleven events has been retained in the amendments.[119] As indicated in the Proposing Release, the list of eleven events was proposed in response to requests for guidance to issuers and other participants in the municipal securities markets as to those events that normally would reflect on the credit supporting the municipal securities, as well as on the terms of the securities that they issue, and thus normally would be considered material. Under the amendments, only the occurrence of one of the specified events will, if material, create an obligation to send a notice to the repository.

The determination of whether other events also should be the subject of notification pursuant to the information undertaking is left to the parties. For example, some commenters requested that the list of events be expanded to address circumstances when the notified events have been cured or rectified, as well as other favorable developments.[120] The parties would be free to add such matters to the undertaking. Issuers also may wish to send information regarding material developments to the repositories, to ensure equal access to that information by all investors and participants in the market, regardless of whether the particular development is subject to the undertaking.[121]

Some commenters were concerned that permitting issuers and obligors to send any notices or information they wished would flood the repositories. Given the fact that event notices generally are short, it appears that the repositories would be able to handle the flow of notices. The Commission will, however, monitor developments in this area.

Some commenters expressed concern that the event described as "matters affecting collateral" was too broad.[122] In response to such observations, that reference has been revised to reflect more clearly the types of events relating to collateral that could affect the creditworthiness of the security being offered. For instance, the item was not intended to require disclosure in the event of a drop in revenues or receipts securing payment. Rather, as more clearly indicated in the revised amendments, it is intended to encompass the release, substitution, or sale of property securing repayment of the securities being offered.[123]

Commenters also questioned whether the event relating to adverse tax opinions or events affecting the tax-exempt status of the security would include events not specific to an issuer, such as tax law changes which may affect a multitude of issuances and which are broadly reported.[124] They argued that there is no need for each issuer to make that disclosure, which may overwhelm the repositories. The amendments do not include a uniform requirement for notification of events having widespread impact that are widely reported. Frequently, individual issuer disclosure may not affect the total "mix" of information available to investors, for example where Congress amends tax rates or alternative minimum tax rules that could affect an investor's yield. On the other hand, it may not be clear, absent individual disclosure, which classes of outstanding securities are affected by the general events, for example, where the tax law change affects a particular type of municipal security or financing structure.

It is possible that an "event" affecting the tax-exempt status of the security may include the commencement of litigation and other legal proceedings, including an audit by the Internal Revenue Service, when an issuer determines, based on the status of the proceedings and their likely impact on holders of the municipal securities, among other things, that such events may be material to investors.

Commenters expressed concern that the party providing the undertaking may not have knowledge of the occurrence of events affecting other parties that might be called for by the provisions of the rule.[125] This concern should be addressed by the revised approach of enabling the parties to the transaction to determine who will provide the undertakings. For example, in the conduit context, the covenant could be provided by the person that is committed by contract or other arrangement to support payment of debt service, rather than the conduit issuer.

[114] *See* Rule 15c2–12(b)(5)(iii).

[115] *See* paragraph (b)(5)(i)(B) of the Proposed Amendments. *See also*, Letter of A.G. Edwards; Letter of Chemical Securities; Letter of J.J. Kenny Co., Inc. ("J.J. Kenny Co."); Letter of MSRB.

[116] *See, e.g.*, Letter of Chemical Securities; Letter of Goldman Sachs; Letter of George K. Baum; Letter of PSA.

[117] *See, e.g.*, Letter of CDFA; Letter of Gust & Rosenfeld; Joint Response; Letter of Municipal Treasurers Association; Letter of Rauscher Pierce Refsnes, Inc.; Letter of Standish Ayer & Wood, Inc.

[118] *See, e.g.*, Letter of Chemical Securities; Letter of Edward D. Jones & Co.; Letter of Finance Authority of Maine; Letter of Ferris Baker Watts; Letter of Norwest Investment Services, Inc.; Letter of Prudential Investment Corp.

[119] The introduction to the list also has been clarified to indicate that the events relate specifically to the securities being offered. *See* Rule 15c2–12(b)(5)(i)(C).

[120] *See, e.g.*, Letter of NAST; Letter of the Treasurer of State of California.

[121] Several commenters have expressed concern that statements by various elected officials made in a political context relating to an issuer must now be included in information provided to a repository. The amendments contain no such requirement. Moreover, these concerns appear to be based upon a misunderstanding of the reminder to issuers in the Interpretive Release that investors may rely on a variety of formal and informal sources for continuing information on municipal issuers, including public statements and press releases concerning an entity's fiscal affairs made by municipal officials, particularly in the absence of a more standardized mechanism for disseminating information about the municipal issuer to the market as a whole. The caution contained in the Interpretive Release that the antifraud provisions may apply to releases of information to the public reasonably expected to reach investors and the trading market does not mean, as some commenters inferred, that such statements are *per se* material; nor do the amendments require that such statements, even where material, be provided to the repositories.

[122] *See, e.g.*, Letter of ABA Business Law Section; Letter of ABA Urban Law Section; Letter of NABL; Letter of NCHFFA; Letter of New York State Housing Finance Agency; Letter of Orrick Herrington.

[123] *See* Rule 15c2–12(b)(5)(i)(C)(10).

[124] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Orrick Herrington.

[125] *See, e.g.*, Letter of First Southwest Company; Letter of New York Dormitory Authority; Letter of the Treasurer of the State of North Carolina; Letter of City of Pullman, Washington.

The timing for providing the notification has not been changed from the Proposed Amendments, which required that the notice be provided on a "timely" basis. The amendments do not establish a specific time frame as "timely," because of the wide variety of events and issuer circumstances. In general, this determination must take into consideration the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice.

A new paragraph has been added to the amendments [126] that would require a Participating Underwriter to reasonably determine that the undertaking includes an agreement to notify the appropriate repository if the annual financial information is not provided in the stated time frame. Given the expressed concerns of some commenters regarding the difficulty that they would face in determining whether an issuer or other person was in compliance with any of its undertakings,[127] this provision will help inform market participants if annual financial information for such persons has not been made available in the agreed upon time frame.

3. Location of Undertaking in a Written Agreement or Contract

The Proposed Amendments called for the undertaking to be contained in a written agreement or contract for the benefit of holders of municipal securities. Commenters provided a variety of views as to where the undertakings should be memorialized, who should be parties to such undertakings, and the need for flexibility to modify undertakings in the future. Commenters suggested, for instance, that the undertakings could be included in the trust indenture, bond resolution, ordinance, or other legislation, a separate written agreement, or the underwriting agreement or bond purchase agreement.

As discussed in the Proposing Release, many offerings of municipal securities are issued pursuant to a trust indenture setting out the covenants of the issuer for the benefit of the holders of the municipal securities. If there is no trust indenture as part of an offering, as is the case with general obligation and certain other types of bonds, there may be a bond resolution, ordinance, or other legislation. Most commenters addressing this issue considered the trust indenture, bond resolution, ordinance, or other legislation to be appropriate for undertakings to provide secondary market disclosure, because they would create a direct obligation by issuers to bondholders.[128] Commenters also suggested the use of a separate written agreement between the issuer and the trustee as an appropriate method of memorializing undertakings.[129]

Several commenters suggested that the inclusion of the undertakings in an underwriting agreement or bond purchase agreement would be sufficient for purposes of Rule 15c2–12,[130] though another commenter suggested that a promise running to the benefit of the underwriter, whether in a bond purchase agreement or in a separate agreement, would be enforceable by existing and future bondholders only on the basis of a third party beneficiary theory, the availability of which may vary from state to state.[131]

Because commenters were supportive of leaving the determination of the location of the undertaking to the parties, the relevant language of the Proposed Amendments, requiring a Participating Underwriter to look to "undertakings in a written agreement or contract for the benefit of holders of such securities" has been adopted as proposed. Therefore, undertakings may be included in a trust indenture, bond resolution or other legislation, or a separate written agreement. Undertakings also may be included in the bond form itself. This general requirement will create a direct obligation to bondholders, yet will be flexible to address variations in state law, as well as the wide variety of types and structures of offerings in the municipal securities market.

The Commission also recognizes that an issuer's ability to contract may be limited under state law. To the extent that issuers are restricted by statute from entering into long-term contractual arrangements, the undertaking may include a qualifier to its obligation, such as that it is subject to appropriation.[132]

Commenters generally took the view that, while a statement in the final official statement describing any undertakings to provide secondary market disclosure would be an important addition to undertakings in a written agreement or contract, in order to make clear that the undertaking is an obligation of the issuer or obligated person that is enforceable on behalf of bondholders, the undertaking should be in a writing signed by the issuer or obligated person.[133] Statements regarding an issuer's or obligated person's provision of secondary market disclosure made exclusively in an official statement would not satisfy the terms of Rule 15c2–12(b)(5) because they would not create a contract enforceable on behalf of bondholders.

Commenters addressing the inclusion of undertakings in various documents were concerned that the failure to provide continuing disclosure pursuant to the undertakings could be deemed a potential event of default on the securities.[134] Though a failure to comply with the undertaking would be a breach of contract, the rule does not specify the consequences of an issuer's breach of its undertakings to provide secondary market disclosure. As called for by the Joint Response, as well as other commenters, remedies for breach of any undertaking under applicable state law are a subject for negotiation between the parties to the Offering. To avoid uncertainties of enforcement, the parties

[126] *See* Rule 15c2–12(b)(5)(i)(D).

[127] *See, e.g.*, Letter of Gust & Rosenfeld.

[128] *See, e.g.*, Letter of Merrill Lynch. Certain commenters considered that undertakings in a trust indenture could prove inflexible, as well as difficult to modify if they became inappropriate in the future. Letter of ABA Business Law Section. Other commenters considered that the issue of flexibility could be addressed through careful drafting. Letter of Morgan Stanley; Letter of Rauscher, Pierce, Refsnes, Inc.

[129] *See* Letter of Chapman and Cutler (suggesting that an agreement could be made between an issuer and a trustee or between the issuer and a NRMSIR); Letter of Rauscher, Pierce, Refsnes, Inc. These commenters noted that such agreements provide flexibility for the future modification of the type, timing, or presentation of secondary market disclosure, as well as remedies in the event of a breach of the agreement.

[130] *See e.g.*, Letter of Mudge Rose.

[131] *See* Letter of Morgan Stanley. Morgan Stanley also suggested that an underwriting agreement was an unsatisfactory vehicle for undertakings to provide secondary market disclosure because an underwriter of a specific bond issue should not be the recipient of a long-term contract of this type. *See* Letter of Morgan Stanley. Other commenters agreed that undertakings should be for the benefit of holders of municipal securities, and that there should be no requirement that undertakings be made for the benefit of Participating Underwriters. *See, e.g.*, Letter of Merrill Lynch (noting that "the holders of the securities have the greatest interest in enforcing the covenant to provide information and are in the best position to evaluate whether affirmative efforts to enforce the covenant should be undertaken").

[132] Some commenters were concerned that in some jurisdictions, an issuer's ability to agree to provide information beyond a one year period might be restricted by state law. To address such concerns, inclusion of a condition subsequent in the covenant, such as subject to appropriation, might be appropriate. It is anticipated, however, that should funds that would enable the issuer to provide the agreed upon information not be appropriated, disclosure of such fact would be made by notice to the repositories pursuant to Rule 15c2–12(b)(5)(i)(D).

[133] *See, e.g.*, Letter of Chemical Securities; Letter of Dain Bosworth, Inc.; Letter of Dillon, Read & Co., Inc.

[134] Commenters argued that an issuer's failure to comply with undertakings to provide secondary market disclosure should not result in an event of default. *See, e.g.*, Letter of ABA Urban Law Section; Letter of State of Washington, Office of the Treasurer; Letter of Colorado Municipal Bond Supervision Advisory Board.

to a transaction are encouraged to enumerate the consequences in the undertaking, including the available remedies, for breach of the information undertaking.

B. Recommendation of Transactions in Municipal Securities

The Proposed Amendments would have prohibited any broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it had specifically reviewed the information the issuer of such municipal security had undertaken to provide.[135] The purpose of this provision of the Proposed Amendments was to assist dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities by requiring them to consider the most current information before making a recommendation.

In view of the importance of secondary market liquidity in municipal issues, the Commission requested comment on whether the Proposed Amendments would have a substantial or long-lasting effect on market liquidity. This request for comment was based on concerns raised about whether municipal securities dealers would be willing to effect secondary market transactions in a broad range of municipal securities if review was required on a recommendation by recommendation basis.

Many commenters strongly criticized this provision of the Proposed Amendments. The majority of commenters responded that requiring the review of information prior to making a recommendation on the purchase or sale of a municipal security would create substantial compliance burdens for dealers.[136] Commenters also noted that the specific requirement to review information either would impel dealers to hire larger research and analysis staffs,[137] or, more likely, would cause dealers to restrict the issuers whose municipal securities they would trade to a smaller number of large and frequent issuers.[138] Commenters predicted that, as a result, liquidity for all but the largest and most frequent issuers would be reduced.[139]

Commenters proposed alternatives to the recommendation prohibition, including basing the type of review of a municipal security, and disclosure about such review, on whether the investor was an institutional or retail investor,[140] or on the type of municipal security recommended.[141] Other commenters suggested the continued reliance on the reasonable basis standard inherent in the MSRB's suitability rule, G–19, and the antifraud provisions, as discussed by the Commission in the 1988 and 1989 Releases proposing and adopting Rule 15c2–12, as well as the Interpretive Release.[142]

As adopted, this provision has been modified in a number of respects to respond to concerns expressed by commenters. In particular, the amendments replace the proposed review standard with a requirement that dealers have procedures in place that provide reasonable assurance that they will receive promptly any notices of material events regarding the securities that they recommend. The events are any of the eleven events disclosed as described in Rule 15c2–12(b)(5)(i)(C), or the notice of failure to provide annual financial information in accordance with an undertaking as described in Rule 15c2–12(b)(5)(i)(D) with respect to that security. Many dealers currently subscribe to electronic reporting systems that give notice of significant events made public by municipal issuers. To comply with the rule's requirement, these dealers should make certain that these systems receive, directly or indirectly, material event notices for issues the dealer recommends. In addition, dealers should develop procedures to ensure that notices of such events will be available to the staff responsible for making recommendations.

In the Commission's view, the recommendation provision, as modified, should substantially reduce the concerns of commenters with respect to compliance burdens and effects on liquidity. It also will help ensure that dealers will consider the material event notices that issuers produce, thus enabling them to have an adequate basis on which to recommend[143] municipal securities.

Moreover, even though the amendments do not require that dealers directly review an issuer's ongoing disclosure before making each recommendation, the Commission agrees with those commenters that said that additional information made available by issuers will be taken into account by dealers making recommendations regarding that security, under the MSRB's fair dealing and suitability rules, and the antifraud provisions.[144] In addition to the Commission's past interpretations of the responsibilities of dealers to have a reasonable basis for their recommendations, the MSRB repeatedly has emphasized that secondary market disclosure information publicized by issuers must be taken into account by dealers to meet the investor protection standards imposed by its investor protection rules. Specifically, MSRB rule G–17 requires dealers to disclose material facts of a transaction to the customer; MSRB rule G–19 requires dealers to ensure that any transaction recommended to the customer is suitable for that customer; and MSRB rule G–30 requires dealers to ensure that the prices set for customer transactions are fair and reasonable. In its comment letter, the MSRB noted that "[i]f a dealer is not aware of major financial and other material developments affecting an issuer's securities, it is difficult or impossible for the dealer to comply with these requirements."[145]

For example, if a dealer reviews an electronic reporting system for material events relating to a security, and finds that an issuer has submitted a notice that it has failed to provide annual financial information on or before the date specified in the written agreement or contract,[146] that fact would be a

[135] *See* paragraph (c) of the Proposed Amendments.

[136] *See* Letter of PSA (noting that paragraph (c) would require dealers to create records showing that they had reviewed municipal securities).

[137] *See, e.g.*, Letter of Chapman and Cutler (brokers with fewer analysts will be at a competitive disadvantage); Letter of Morgan Stanley (noting that in order to comply with paragraph (c) as proposed, reliance on third-party service providers for information analysis would be required).

[138] *See, e.g.*, Joint Response; Letter of PSA; Letter of Gabriel, Hueglin & Cashman.

[139] *See, e.g.*, Joint Response; Letter of PSA.

[140] Letter of Investment Company Institute ("ICI"). *See also* Letter of MSRB; Letter of NABL. NABL suggested disclosure by dealers as to whether a party has committed to provide secondary market disclosure, and if not, the consequences of investing in the securities.

[141] *See, e.g.*, Letter of Edward D. Jones & Co. (suggesting application of the Proposed Amendments only to non-rated or special assessment bonds); Letter of NABL (suggesting exemptions from the amendments to Rule 15c2–12 for issuers that obtain and maintain an investment grade rating, and for general obligation bonds and revenue bonds issued to finance essential government purposes).

[142] *See, e.g.*, Letter of PSA; Letter of A.G. Edwards & Sons, Inc. (reviewing issuer's disclosure is not the only way to form the basis for a recommendation).

[143] As noted in the Proposing Release, most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer.

[144] *See, e.g.*, Letter of MSRB (emphasizing that, in the Board's view, dealers would be responsible for continuing disclosure information available in NRMSIRs even without the specific "review" requirement); Letter of Paine Webber.

[145] Letter of MSRB (noting the requirements of the MSRB's rules in commenting that the Proposed Amendment's requirement to review periodic information is not a practical option for dealers).

[146] *See* Rule 15c2–12(b)(5)(i)(D).

significant factor to be taken into account when the dealer formulates the basis for a recommendation of such securities. While the dealer would not be prohibited *per se* from recommending such municipal securities, notice that the issuer has failed to provide annual financial information would be the type of material information required to be disclosed to the customer pursuant to MSRB rule G–17.[147] Such a notice also would trigger a further inquiry by the dealer to assure itself that it is cognizant of the condition of the issuer or obligated persons, despite the absence of promised information. This also would be true if a dealer attempts to obtain an issuer's annual financial information, finds that it has not been submitted to any repository, and the dealer had no record of the issuer submitting a notice to this effect. In such cases, further research may be necessary or advisable prior to making a recommendation in the issuer's securities.

C. Information Repositories

1. Background

Under Rule 15c2–12, as adopted in 1989, NRMSIRs essentially serve the function of disseminators of official statements on behalf of Participating Underwriters.[148] The option of Participating Underwriters to transfer their final official statement delivery obligations to NRMSIRs has encouraged the development of NRMSIRs.[149] The three existing NRMSIRs are private vendors that gather and disseminate final official statements pursuant to Rule 15c2–12. In addition, although not required under existing provisions of the rule, they provide other current information about municipal issuers to the primary and secondary municipal securities markets.[150]

As a result of the amendments, NRMSIRs will play an expanded role in the collection and dissemination of secondary market information. In addition to the collection and dissemination of final official statements, they will collect and disseminate annual financial information, as well as notices of material events. The Commission is sensitive to the need of NRMSIRs for flexibility, especially with respect to the timing requirements for the dissemination of notices of material events. The Commission will monitor developments in the municipal securities market as participants adapt to the changes in Rule 15c2–12, and fully expects that the current and potential NRMSIRs are capable of adjusting to their expanded role. The Commission is of the view that NRMSIRs, as private information vendors, will have sufficient economic incentives to serve their expanded functions resulting from the amendments to Rule 15c2–12, even in the absence of the more specific review requirement of the recommendation prohibition of the Proposed Amendments.[151]

2. Definition of Nationally Recognized Municipal Securities Information Repository

The Commission requested comment on whether the term "NRMSIR" should be defined in Rule 15c2–12, and whether specific standards should be established for NRMSIRs. If standards were to be established in the rule, the Commission requested comment on whether proposed standards set forth in the release were adequate.[152] The majority of state-based information gatherers and disseminators, and other NRMSIRs that addressed the issue of defining the term "NRMSIR" supported maintaining the guidelines already established by the Commission in the 1989 Release.[153] After reviewing the comment letters, the Commission has determined that the guidance established in the 1989 Release for NRMSIRs should be modified only as necessary to reflect the amendments to Rule 15c2–12. In determining whether a particular entity is a NRMSIR the Commission will now consider, among other things, whether the repository:

(1) Is national in scope;

[147] *See* MSRB Manual (CCH) ¶ 3581.30 (interpreting MSRB rule G–17 to require that a dealer disclose, at or prior to a sale, all material facts concerning the transaction, including a complete description of the security). *See also* 1988 Release at n. 50 and accompanying text.

[148] Under Rule 15c2–12(b)(4), underwriters must deliver final official statements to potential customers for a 90 day period after the close of the underwriting period. The underwriters' 90 day delivery obligation is shortened to 25 days if the final official statement can be obtained from a NRMSIR.

[149] Since the Commission adopted Rule 15c2–12, the Division of Market Regulation issued three no-action letters recognizing national information vendors as NRMSIRS, based on the standards set out in the July 1989 Release. *See* Letters from Richard G. Ketchum, Director, Division of Market Regulation to: Joseph V. Riccobono, Executive Vice-President, American Banker-Bond Buyer (Jan. 4, 1990); J. Kevin Kenny, President, Chief Executive Officer, J.J. Kenny Co. (Jan. 4, 1990); and Michael R. Bloomberg, President, Bloomberg, L.P. (Jan. 11, 1990). Recently, the Commission has received inquiries from additional information vendors desiring to be recognized as NRMSIRs.

[150] NRMSIRs are not the only source of information in the municipal market. The MSRB has developed its Municipal Securities Information Library ("MSIL") system, which presently collects information and disseminates it to market participants and information vendors. The Official Statement and Advance Refunding Document-Paper Submission System ("OS/ARD") of the MSIL collects and makes available on magnetic tape and on paper official statements and advance refunding notices. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. As a part of the MSIL system, the MSRB commenced operation of its Continuing Disclosure Information ("CDI") pilot system in January, 1993. The CDI system is a central repository for voluntarily submitted official continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992) 57 FR 12534. Neither the MSIL OS/ARD system nor the CDI system is a NRMSIR; the Commission has previously indicated that it would consider the competitive implications of a MSRB request for NRMSIR status. *See* Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

[151] *See, e.g.*, Letter of PSA (noting that the suggestion made by some market participants that municipal securities dealers will not utilize information they have long sought is implausible), Letter of Ferris Baker Watts (information will be used if it is available).

[152] The Commission suggested that NRMSIRs (a) maintain current, accurate information about municipal securities, including final official statements, the issuer's annual final information, and issuer's notices of material events; (b) have effective systems for the timely collection, indexing, storage and retrieval of these documents; and (c) be capable of national dissemination of final official statements, annual financial information, and notices of material events through electronic dissemination systems, in response to telephone inquiries, and hard copy delivery via facsimile, by mail and by messenger service. The Commission also stressed the importance of timely public availability upon receipt of information by a NRMSIR.

[153] *See, e.g.*, Letter of Bloomberg L.P.; Letter of Cypress Capital Corp. (a dealer chosen by the Louisiana Municipal Association to assist it in developing a repository to collect and disseminate information on Louisiana issuers of municipal securities). In discussing NRMSIRs in the 1989 Release, the Commission noted that in determining whether a particular entity is a NRMSIR, it would look, among other things, at whether the repository: (1) is national in scope; (2) maintains current, accurate information about municipal offerings in the form of official statements; (3) has effective retrieval and dissemination systems; (4) places no limit on the issuers from which it will accept official statements or related information; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees. *See* 1989 Release at n. 65.

(2) Maintains[154] current, accurate[155] information about municipal offerings in the form of official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2–12;

(3) Has effective retrieval and dissemination systems;

(4) Places no limits on the persons from which it will accept official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2–12;

(5) Provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and

(6) Charges reasonable fees.

While NRMSIRs may charge reasonable fees[156] for the dissemination of information, they may not charge issuers for accepting information provided by issuers in accordance with Rule 15c2–12.[157] In response to concerns raised by commenters, the Commission also notes that giving preferential treatment to certain brokers, dealers, and municipal securities dealers by giving them market information before it is made available to all customers would be wholly inconsistent with recognition as a NRMSIR.[158]

Comment also was requested on the ability and willingness of both potential NRMSIRs, and those presently operating under no-action letters, to meet the dissemination standards discussed in the Proposing Release. NRMSIRs responded that they can meet these standards.[159] In order to implement these standards, the Commission has determined that existing NRMSIRs should reapply for recognition from the Commission under the revised criteria to continue to function as NRMSIRs.

3. State Information Depositories

The Commission also requested comment on whether a state-based depository could serve as an effective means to disseminate information to the market for a nationally traded security, thus enabling the appropriate parties to fulfill their disclosure obligations using a state-based depository. Commenters expressed divergent views on this issue.[160] No state responded directly in response to the Commission's request for comment on whether states are willing to make the necessary financial commitment to create a state-based system. The Comptroller of the State of New York pointed out, however, that his office already collects financial data from local governments, and that there "is an appropriate and important function which the states may perform in the secondary market disclosure process."[161] A number of third party state-based information collectors also stated that they were in the process of creating state-based repositories.[162] Other such third party state-based information collectors pointed out that they already had working depositories in place.[163]

Based on these comments, and in light of existing disclosure mechanisms and recent legislation in several states designed to enhance secondary market disclosure,[164] it appears that states can play a beneficial role in enhancing disclosure in the municipal securities market.[165] State-based depositories will be in a special relationship with filers of disclosure information to provide for convenient and efficient dissemination. The Commission therefore encourages states to develop state-based depositories.

To encourage the development of state-based depositories, the Commission has amended Rule 15c2–12 to require that Participating Underwriters reasonably determine that the information undertaken to be provided, in addition to being submitted to the NRMSIRs, or, in some cases, to the MSRB, will be submitted to a state information depository ("SID"), if an appropriate SID has been established in that state. Further, as discussed below,[166] an exemption conditioned on making annual financial information available upon request or to a SID, and providing notices of material events to each NRMSIR or the MSRB, and to a SID, has been adopted. An appropriate SID would be a depository operated or designated[167] by the state that receives information from all issuers within the state, and makes this information available promptly to the public on a contemporaneous basis.[168] The Commission staff is prepared to provide guidance in particular instances regarding a SID's qualification for purposes of the rule.

4. Information Delivery Requirements

The Proposing Release asked to whom the required information should be

[154] In the past, the Division of Market Regulation has required that each NRMSIR maintain copies of all disclosure documents. In view of recent requests from information collectors and disseminators, the Division of Market Regulation will review, on a case by case basis, NRMSIR proposals to satisfy the requirement to maintain copies of disclosure documents through a contract with another entity (including the MSRB) that will maintain copies. *See* Letters from Laurence M. Landau, Vice President, Dow Jones Telerate, to Elizabeth MacGregor, Division of Market Regulation, SEC, (July 18, 1994) and to Gautam S. Gujral, Division of Market Regulation, SEC (August 4, 1994). *See also* Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial). This flexible approach, requested by industry participants, may allow NRMSIRs to reduce the cost at which they can collect and disseminate disclosure information to broker-dealers and investors.

[155] It should be noted that NRMSIRs are not being required to verify the accuracy of the information provided them. NRMSIRs are required to accurately convey the information provided to them.

[156] *See* 1989 Release.

[157] *See, e.g.*, Letter of Maine Municipal Bond Bank; Letter of National Association of Independent Public Financial Advisers (NRMSIR users, not issuers, should pay the NRMSIR costs).

[158] *See, e.g.*, Letter of Colonial Management Associates, Inc.

[159] Letter of Bloomberg L.P.; Letter of J.J. Kenny Co.; Letter of The Bond Buyer.

[160] With one notable exception, national information vendors generally did not see a need for state-based repositories and argued that state-based repositories would indeed add to the complexity of collecting and disseminating information. *See, e.g.*, Letter of J.J. Kenny Co. Some state-based information gatherers and disseminators, however, argued that they already had created mechanisms for the collection and dissemination of information, and their systems are working well. The National Association of State Auditors, Comptrollers and Treasurers ("NASACT") pointed out that issuers and other obligors will probably file with state-based repositories, with whom they are accustomed to working and with whom they typically must file in any event for regulatory purposes unrelated to secondary market disclosure. NASACT argued that while the state repositories do not wish to compete with NRMSIRs, state-based repositories can serve an important role in enhancing the accessibility of disclosure information for repackaging by the NRMSIRs. *See* Letter of NASACT.

[161] *See* Letter of the Office of the State Comptroller, State of New York.

[162] *See, e.g.*, Letter of Cypress Capital Corporation (Louisiana Municipal Security Disclosure Board "intends to be in a position to comply with the standards developed by the Commission for NRMSIRs").

[163] *See* Letter of Municipal Advisory Council of Texas; Letter of Ohio Municipal Advisory Council.

[164] South Carolina recently enacted legislation requiring issuers to agree in a bond indenture to file an annual independent audit within a specified number of days of the issuer's receipt thereof and certain event information with a central repository. South Carolina Senate Bill 1182, (effective September 1, 1994) to be codified in S.C. Code Ann. Chapter 1, Title 11, Section 11–1–85 (1976). Similarly, Tennessee recently adopted legislation authorizing the adoption of rules to facilitate secondary market disclosure by any public entity, including the form and content of that disclosure. Tenn. Code Ann. Sec. 9–21–151 (a) and (b)(2).

[165] *See, e.g.*, Letter of the Office of the State Comptroller, State of New York.

[166] *See* Section II.D.1. *infra*.

[167] There is no requirement that SIDs be instrumentalities of a state. A number of private organizations already function as state-based repositories, at times at no cost to the taxpayer. The Commission defers to each state's determination whether to have a private or public entity be its SID.

[168] As with NRMSIRs, for a SID to give preferential treatment to a NRMSIR by giving it market information before it is made available to other NRMSIRs would be wholly inconsistent with functioning as a SID.

delivered. It also requested comment on the feasibility of requiring NRMSIRs to inform the MSRB when they receive disclosure information from issuers, and whether such information also should be required to be placed with the MSRB, in addition to or in lieu of a NRMSIR. The NRMSIRs did not address the issue of requiring them to inform the MSRB whenever they received disclosure information from an issuer, although one commenter argued that designating the MSRB as a repository only would add an unnecessary layer to the dissemination process.[169] Other commenters suggested designating a single central repository.[170] Similarly, some commenters suggested imposing a requirement that disclosure information be delivered to all NRMSIRs,[171] while others suggested that NRMSIRs be required to share the information received with other NRMSIRs,[172] and a third group preferred the establishment of a central index.[173] State-based information gatherers and disemminators had diverging views on this issue.[174]

Based on these comments, the Commission has determined to require that annual financial information undertaken to be provided be deposited with each NRMSIR and the appropriate SID in the issuer's state. Any audited financial statements submitted in accordance with the undertakings also must be delivered to each NRMSIR and to the SID in the issuer's state, if such a depository has been established. The requirement to have annual financial information and audited financial statements delivered to all NRMSIRs and the appropriate SID is a modification of the Proposed Amendments. This modification will ensure that all NRMSIRs receive disclosure information directly. It also permits the Commission to adopt the amendments without a delay for the creation of a central index or a system of information sharing among NRMSIRs.[175] The requirement to send information to all NRMSIRs rather than a single NRMSIR of the issuer's or obligated person's choice, should not impose significant burdens or costs, other than duplication and mailing costs. Furthermore, this requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allays the anti-competitive concerns raised by the creation of a single NRMSIR.

In contrast to annual financial information, under the amendments, notices of material events, as well as notices of a failure by an issuer or other obligated person to provide annual financial information must be delivered to each NRMSIR or the MSRB, and the appropriate SID. The Commission is of the view that permitting issuers and obligated persons to file such notices either with each NRMSIR or with the MSRB (as well as the appropriate SID) will facilitate prompt and wide disclosure. The amendments reflect the preference of some commenters for filing such notices in one central place, such as the MSRB, rather than having to file with multiple NRMSIRs. The Commission expects that if notices are filed with the MSRB, the MSRB will make these notices available to all NRMSIRs on a prompt and contemporaneous basis.

5. Timing of Dissemination

Due to the time sensitive nature of notices of material event and failures to provide annual financial statements, it is important that such notices are disseminated quickly. These market requirements will dictate that disseminators have a system in place by which information vendors can make such notices available to broker-dealers and investors quickly and contemporaneously.

NRMSIRs and other information vendors have indicated in their comment letters that under certain circumstances a 15 minute turnaround[176] time for notices of material events, and a 24 hour turnaround period for annual financial information may be feasible, and, in some instances, already is in place.[177] Nonetheless, because the ultimate scope of the information undertakings was not known to the existing and potential NRMSIRs at the time they submitted their comments, the Commission intends to discuss with the NRMSIRs during the recognition process appropriate and practicable turnaround standards for information re-dissemination. Because SIDs are alternative sources of information for every type of disclosure, the Commission does not intend to impose strict turnaround times for SIDs. Instead, SIDs should provide the Commission and users with a clear statement of turnaround times that they will meet consistently.

6. Technological Considerations

The Commission also received many suggestions from information gatherers and vendors on streamlining the filing of disclosure information. These suggestions included requiring electronic filing of disclosure information, providing filings on computer disks and providing information to NRMSIRs as images of original source documents rather than exclusively as coded text.[178] Rather than dictate standards, the Commission encourages municipal securities market participants to coordinate their requirements and preferences on an industry-wide basis.

D. Exemptions

The Proposed Amendments contained two new exemptions, which are being

---

[169] Letter of Bloomberg L.P.

[170] *See, e.g.*, Artemis Capital Group, Ltd. (proposing that the Commission designate the MSRB's MSIL system as the single central repository); Letter of Chapman and Cutler (there should be one central source of information).

[171] *See, e.g.*, Letter of J.J. Kenny Co.; Letter of National Association of Independent Public Financial Advisers.

[172] *See, e.g.*, Letter of MSRB; Letter of Richard A. Ciccarone.

[173] Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of The Bond Buyer.

[174] The Ohio Municipal Advisory Council stated that it is feasible to require repositories to inform the MSRB as to which issuers have released information to it. Under Cypress Capital Corporation's proposal, the indexing party would receive descriptions of all materials received by the Louisiana Repository. *But see*, Letter of NASACT (requirement that a repository be required to notify a central index each time an item of information is received by the repository is unduly burdensome and unnecessary).

[175] Some commenters expressed an interest in creating a central index and an information sharing system. Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of Dow Jones Telerate, Inc. The Commission is prepared to review such mechanisms for centralized collection and dissemination if requested to do so.

[176] The Commission considers "turnaround time" or "turnaround period" to mean the time between which a NRMSIR initially receives information, and the time when such information is made available to the public. NRMSIRs will be required to make available the full text of notices of material events, and post the receipt and availability of other documents within the designated turnaround time period.

[177] The Bond Buyer stated that it broadcasts, through its Munifacts News product, material events and time critical announcements within 15 minutes of their receipt to municipal market participants throughout the country. It stated that it also posts documents within 24 hours of a document's receipt to the Bond Buyer's On-line Index which is updated throughout the day. Letter of The Bond Buyer. Similarly, Dow Jones Telerate stated that electronic dissemination will allow the turnaround time of 24 hours for an official statement and 15 minutes for secondary disclosure documents on material events to be feasible. Letter of Dow Jones Telerate. Material information is electronically disseminated on a "real time" basis by Bloomberg L.P. Letter of Bloomberg L.P.

[178] J.J. Kenny Co. requested that documents be required to be filed as images of original source documents rather than exclusively as coded text. Dow Jones Telerate requested that Official statements be filed along with one electronic disk copy of the original Word Processing/Desktop publishing file with the label marked as to which software and version was used. For secondary market disclosure documents, Telerate advises using the NFMA proposed worksheets. The Bond Buyer stated that "collection would be most efficient if documents were in ASCII and a common word processing or publishing format"

adopted with certain modifications. A third new exemption from the annual financial information requirement, for short-term securities, also is being adopted. In addition, Rule 15c2–12's limitation to primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more, and its existing exemptions, also apply to the amendments.[179]

1. Small Issuer Exemption

The Proposed Amendments would have exempted from the provisions of the undertaking and recommendation prohibitions of the rule municipal securities issued in Offerings by issuers that had (i) less than $10,000,000 in principal amount of securities outstanding, including the offered securities and (ii) issued less than $3,000,000 in aggregate amount of municipal securities in the most recent 48 months preceding the offering.

A number of commenters discussed the appropriateness of the proposed dollar exemption, with comments ranging from a call for increased thresholds to no thresholds at all.[180] Some commenters believed that the thresholds should be increased, because many small municipalities would exceed these thresholds if they delay their financings in order to issue a greater amount of bonds at one time. The commenters argued that these are small, infrequent issuers with limited trading in the secondary market and the cost of compliance would outweigh the benefits received from improved secondary market disclosure.[181]

Other commenters took exception to the proposed thresholds because they were too high. These commenters argued that the exemption as proposed would exclude from coverage of the rule the types of issuers who have historically had deficient disclosure practices and disproportionate numbers of defaults.[182] A number of commenters also argued that the $3 million/48 month component of the threshold was too complex.[183]

As adopted,[184] the exemption retains the aggregate $10,000,000 limitation, but eliminates the $3,000,000 threshold. Instead, in addition to falling under the $10,000,000 in outstanding securities threshold, the exemption is conditioned upon an issuer or obligated person providing a limited disclosure undertaking. Under this undertaking, financial information and operating data concerning each obligor for which financial information or operating data is presented in the final official statement, must be provided upon request to any person, or be provided at least annually to the appropriate SID. The undertaking would specify the type of financial information and operating data that will be made available annually, which must include financial information and operating data that is customarily prepared by the obligated person and is publicly available. The final official statement must describe where and how the financial information and operating data can be obtained.

Financial information and operating data of governmental issuers generally are subject to freedom of information laws, and thus would be publicly available for purposes of this condition of the exemption. Conduit borrowers generally provide annual financial information to trustees, credit enhancers, or the financing agency that issued the municipal securities, and thus would have no difficulty complying with this standard if that information is made publicly available. To the extent that an obligated person does not currently publicly disclose that information, they are free to specify the type of information they are undertaking to provide on an ongoing basis, but they must agree to provide some information. That information need not be the same type of information presented in the official statement. Nor would these exempt persons have to release their audited financial statements, unless they otherwise customarily prepare and make their audited financial statements publicly available. Moreover, the limited disclosure undertaking need only cover those obligors for which financial information or operating data is provided in the official statement.

In addition to providing financial information and operating data annually, notices of material events must be sent to each NRMSIR or to the MSRB, and the appropriate SID. This public information condition has been adopted in response to comments highlighting the need for information regarding small issuers accessing the public debt market.[185]

The threshold of $10,000,000 has been retained, notwithstanding comments that it was too high or too low. According to statistics provided by one commenter,[186] in 1993, 71% of the approximately 52,000 municipal issuers had under $10,000,000 in outstanding municipal securities. Accordingly, the amendments as proposed already provided significant exemptive relief for small issuers. Indeed, the fact that a majority of issuers fall below that threshold supports conditioning the exemption on a commitment to provide a limited amount of secondary market information from exempt issuers. Even with that condition, a significant percentage of offerings would remain totally exempt from the amendments as adopted, because over 20% of the total issuances in 1993 were under $1,000,000.[187] As these statistics demonstrate, the exemption should exclude a large percentage of small infrequent issuers.

Commenters also questioned how the aggregate thresholds were measured, including whose securities would be included and whether the exemption applied only to outstanding securities that were sold in Offerings subject to the rule.[188] Many commenters indicated that the thresholds should be separately applied to each issuer of municipal securities and each underlying obligor.[189] Thus, in the case of conduit issuers that have no liability on the municipal securities, commenters argued that the thresholds should be determined by reference to the persons who are the beneficiaries of the

[179] Former paragraph (c) of Rule 15c2–12 was proposed to be, and has been redesignated as paragraph (d)(1). This paragraph exempts primary offerings of municipal securities in authorized denominations of $100,000 or more, if such securities: (1) are sold to no more than 35 investors, each of whom the underwriter reasonably believes is capable of evaluating the investment and who is not purchasing with a view to distribution; (2) have a maturity of nine months or less or; (3) at the option of the holder may be tendered to an issuer at least as frequently as every nine months.

[180] *See, e.g.* Letter of ALHFA; Letter of CDFA; Letter of NFMA; Letter of National Association of Independent Public Finance Advisors; Letter of Prudential Investment Corp.; Letter of PSA; Letter of Washington State Auditor.

[181] *See, e.g.*, Letter of NAST; Letter of SIA.

[182] *See, e.g.* Letter of Chemical Securities; Letter of Eaton Vance Management; Letter of Edward D. Jones & Co.; Letter of Morgan Stanley; Letter of National Association of Independent Public Finance Advisors; Letter of Norwest Investment Services.

[183] *See, e.g.*, Letter of APPA; Letter of The Bank of New York; Joint Response.

[184] *See* Rule 15c2–12(d)(2).

[185] *See* Joint Response. A number of other commenters expressed concern about the lack of information on issuers in market segments in which the higher proportion of defaults have occurred. *See* note 182, *supra* and accompanying text. The effective date for this information undertaking condition on the small issuer exemption will be delayed until January 1, 1996. *See* Section II.E., *infra*.

[186] *See* Letter of The Bond Buyer.

[187] *See* Letter of The Bond Buyer. The requirements of Rule 15c2–12, as amended, may not be avoided by breaking up an offering into several offerings of less than $1,000,000, where the offerings are of the same class of securities and are for the same purpose.

[188] *See, e.g.*, Letter of ABA Urban Law Section; Letter of CIFA; Letter of Colorado Municipal Bond Supervision Advisory Board.

[189] *See, e.g.*, Letter of ALHFA; Letter of CDFA; Letter of Hawkins Delafield & Wood.

financing.[190] Some commenters argued that those issuers that had different types of financings that relied on separate revenue streams for repayment, such as dedicated tax revenues, should not be foreclosed from relying on the small issuer exemption for each financing.[191]

To address the first of these concerns, the amendments have been revised to clarify that the availability of the exemption turns on the amount of outstanding municipal securities for which an issuer or obligated person also is an obligated person. An issuer of municipal securities would need to satisfy the threshold only if it were an obligated person with respect to the security being offered. Under this approach, if a financing agency that is offering obligations that have some recourse to the agency, only those outstanding securities of the agency that likewise are recourse would count toward the threshold. If the financing agency does not issue recourse securities, the exemption will be unavailable only if a conduit borrower obligated on the municipal securities being offered is an obligated person with respect to more than $10,000,000 in outstanding municipal securities. If any one obligated person in an Offering exceeds the threshold, then the entire Offering, including all obligated persons, will be subject to the rule. Subsequent non-recourse offerings by the financing agency would not be affected, but would be subject to a similar test.

With respect to the second concern, however, the amendments require that an obligated person aggregate all its outstanding obligations, even if some are payable from separate dedicated revenue sources. For example, a city or county that issues securities for a number of different purposes could not qualify as a small and infrequent issuer merely because its outstanding securities are payable from separate revenue streams. Thus, while a governmental issuer's outstanding obligations need not be aggregated with that of non-governmental obligated persons, a governmental issuer could not avoid aggregation of its securities by restricting repayment to separate revenue streams.[192]

Commenters also discussed a related issue of what securities would be included in the calculation. Commenters contended that only publicly offered securities should be included in the calculation. Other commenters questioned how short term obligations such as bond anticipation notes, refunded bonds and installment/lease purchase agreements would be treated. Several commenters suggested that the threshold should be measured only against publicly offered, long-term bonds.[193]

The amendments have been clarified in this respect to exclude from the threshold calculation securities that were offered in transactions exempt from Rule 15c2–12 because they were otherwise exempt as private placements and short term financings. In addition, to the extent that an issuer or obligated person is no longer liable for repayment on bonds, as with certain defeased bonds, then such bonds would not be included in the calculation of the threshold for such issuer or obligated person.

A number of commenters indicated that an exemption should be available based on the number of holders of the municipal securities.[194] However, in accordance with concerns voiced by other commenters regarding the difficulty in ascertaining the number of holders due to the fact that most municipal securities are held in street name through a very limited number of depositories,[195] the amendments do not adopt any exemption based on the number of holders of the municipal securities.

A variety of other comments were raised relating to exemptions, and a number of alternative exemptions were proposed, including exemptions based on the type of issuer or the existence of an investment grade rating.[196] Commenters also believed that an exemption should be available for securities covered by bond insurance or other credit enhancement, such as bank letters of credit.[197] Except as described above, the exemptions have not been revised to adopt these suggestions. Commenters, including some bond insurance providers,[198] expressed the view that the existence of credit enhancement does not necessarily eliminate the need for information regarding the underlying credit.

A number of commenters also argued that new exemptions should be added that would mirror exemptions under the Securities Act.[199] Some commenters argued that exemptions should be included for non-profit entities that would have their own exemption from registration under the Securities Act.[200] The Commission is not including any exclusion in the amendments for any such issuers. Issuers accessing the tax-exempt public securities markets have obligations to promote the integrity and efficiency of those markets. As the Commission noted in the Interpretive Release, the high level of defaults in sectors such as healthcare, lifecare, retirement homes and multifamily housing, relative to other market sectors,[201] and the past problems with the sufficiency of information in many of these sectors, weighs heavily against adopting such exclusions.

2. Exemption from the Annual Financial Information Requirement for Short-term Securities

A new exemption has been added to exempt from the requirement for an undertaking calling for annual financial information, Offerings of securities with an 18 month or shorter maturity.[202] The new exemption is in response to comments suggesting that the rule not

---

[190] *See, e.g.*, Letter of Alaska Municipal Bond Bank; Letter of Bose, McKinney & Evans; Letter of CDFA; Letter of Oregon Economic Development Department.

[191] *See, e.g.*, Letter of ABA Business Law Section; Letter of Chapman and Cutler; Letter of NABL.

[192] Significant indicia of whether an issuer in a revenue-type financing is in fact a part of a larger municipality would be whether the issuer's accounts are reflected in the municipality's financial statements and whether the municipality's officials or personnel manage the separate financing programs.

[193] *See, e.g.*, Letter of ABA Business Law Section; Letter of Day Berry & Howard; Joint Response; Letter of Kutak Rock; Letter of the Treasurer of the State of North Carolina.

[194] *See, e.g.*, Letter of ABA Business Law Section; Letter of Kutak Rock; Letter of Mudge Rose; Letter of National League of Cities.

[195] *See, e.g.*, Letter of Bank One Corporation; Letter of Reliance Trust Company.

[196] *See, e.g.*, Letter of ICI; Letter of McDonald & Company Securities; Letter of NABL; Letter of National League of Cities; Letter of NFMA; Letter of New York Dormitory Authority; Letter of Putnam Investment Management; Letter of State of Utah, Office of the State Treasurer; Letter of State of Washington, Office of the State Treasurer.

[197] *See, e.g.*, Letter of Delaware County Industrial Development Authority; Letter of Financial Security Assurance; Letter of McNair & Sanford; Letter of Smith, Gambrell & Russell.

[198] As some commenters indicated, the existence of credit enhancement or other programmatic enhancement features does not eliminate the need for information on underlying obligated persons, particularly where there is a long term guarantee, because of the potential impact of a default on the pricing of the securities. *See* Letter of Kutak Rock on behalf of Financial Guaranty Insurers; Letter of FGIC; Letter of Prudential Investment Corp. *See also* Securities and Exchange Commission, *Report by the Securities and Exchange Commission on the Financial Guaranty Market: The Use of the Exemption In Section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities* (August 28, 1987).

[199] *See, e.g.*, Letter of ABA Business Law Section; Letter of Goldman Sachs; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Thacher Proffitt & Wood.

[200] *See, e.g.*, Letter of Morgan Stanley; Letter of Mudge Rose; Letter of New York Dormitory Authority.

[201] Interpretive Release at Section III.D. *See also* Letter of The Bond Buyer.

[202] Rule 15c2–12(d)(3).

require annual financial information in situations where the securities would mature shortly after, or possibly even before, the annual financial information would be due.[203] The provisions of the amended rule relating to notices of material events, however, would apply to these Offerings absent some other Rule 15c2–12 exemption.

3. Exemptions from the Recommendation Prohibition

The Proposed Amendments also included a new exemption,[204] which would have permitted the recommendation in the secondary market of securities that were not subject to the underwriting prohibition, either because they were sold in a primary offering[205] of municipal securities with an aggregate principal amount of less than $1,000,000, or came within the existing exemptions for limited placements, short-term securities, and securities with demand features,[206] or within the new exemption for small, infrequent issuers.[207] This exemption has been adopted as proposed,[208] with the exception that securities sold in an exempt Offering that is subject to the limited undertaking condition,[209] are not exempt from the application of the recommendation prohibition. Pursuant to this element of the small issuer exemption, dealers must have in place procedures to receive notices of material events.[210]

4. Transactional Exemption

The existing Rule 15c2–12 transactional exemption[211] permits the Commission to exempt any Participating Underwriter from any requirement of the rule. Because Rule 15c2–12, as amended, places requirements on brokers, dealers, and municipal securities dealers in the secondary market, the transactional exemption has been amended to clarify that the Commission has exemptive authority with respect to both Participating Underwriters, in connection with Offerings, and with respect to brokers, dealers, and municipal securities dealers recommending transactions in the secondary market.[212]

E. Transitional Provision

The rule as amended contains a transitional provision for the amendments to Rule 15c2–12.[213] The underwriting prohibition applies to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering on or after the effective date of the rule, July 3, 1995; provided that issuers need not undertake to provide annual financial information for fiscal years ending prior to January 1, 1996. The recommendation prohibition will become effective on January 1, 1996. The Commission is of the view that this delay of six months beyond the effective date of the amendment relating to the underwriting of municipal securities is sufficient to permit participants in the municipal securities market to design procedures for compliance with the provisions of Rule 15c2–12. Brokers, dealers and municipal securities dealers must, therefore, have procedures in place to comply with the recommendation prohibition on or before January 1, 1996. Finally, the limited undertaking condition to the small issuer exemption need not be satisfied for offerings commencing prior to January 1, 1996.

III. Effects on Competition and Regulatory Flexibility Act Considerations

Section 23(a)(2) of the Exchange Act[214] requires the Commission, in adopting rules under the Act, to consider the anticompetitive effects of those rules, if any, and to balance that impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission has considered the amendments to Rule 15c2–12 in light of the standard cited in Section 23(a)(2) and believes the adoption of the amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act.

In addition, the Commission has prepared a final regulatory flexibility analysis ("FRFA"), pursuant to the requirements of the Regulatory Flexibility Act[215] regarding the proposed amendments to Rule 15c2–12. The Commission requested comment on the extent to which current practice deviates from the requirements of the proposed amendments, and the extent to which additional costs may be imposed on small issuers, brokers, dealers, and municipal securities dealers if the amendments are adopted as proposed. The FRFA indicates that the amendments to the rule could impose some additional costs on small broker-dealers and municipal issuers. Nonetheless, the Commission is of the view that many of the substantive requirements of the amendments already are observed, absent access to the continuing information provided by the amendments, by issuers, brokers, dealers, and municipal securities dealers as a matter of business practice, or to fulfill their existing obligations under the antifraud provisions of the federal securities laws. To the extent that the Proposed Amendments would have imposed additional costs on small issuers, brokers, dealers, and municipal securities dealers, in response to commenters' concerns, the Commission has modified the amendments as described.

A copy of the FRFA may be obtained from Janet W. Russell-Hunter, Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Mail Stop 7–10, Washington, DC 20549, (202) 942–0073.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments to Rule 15c2–12

In accordance with the foregoing, Title 17, Chapter II of Title 17 of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, *78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll*(d), 79q, 79t, 80a–20, 80a–

[203] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Chemical Securities; Letter of Day, Berry & Howard; Letter of Kutak Rock; Letter of Maryland Department of Economic and Employment Development.

[204] *See* paragraph (d)(3) of the Proposed Amendments.

[205] This exemption has been modified to clarify that the recommendation prohibition will not apply to primary or secondary market trading where municipal securities are exempt at the time of their original issuance. Several commenters noted that the inclusion of the term "a primary offering of" created confusion, based on the stated purpose of the exemption in the Proposing Release. *See, e.g.*, Letter of Kutak Rock; Letter of ABA Urban Law Section; Letter of Colorado Municipal Bond Supervision Advisory Board; Letter of Day, Berry & Howard. The exemption has been modified to delete that term, thus giving the exemption its intended meaning.

[206] *See* paragraph (d)(1) of the Proposed Amendments.

[207] *See* paragraph (d)(2) of the Proposed Amendments.

[208] Rule 15c2–12(d)(4).

[209] *See* Rule 15c2–12(d)(2).

[210] *See* Rule 15c2–12(b)(5)(i)(C).

[211] Former paragraph (d) of Rule 15c2–12.

[212] The transactional exemption also has been redesignated as paragraph (e) of Rule 15c2–12.

[213] *See* Rule 15c2–12(g).

[214] 15 U.S.C. 78w(a)(2).

[215] 5 U.S.C. 604.

23, 80a–29, 80a–27, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.15c2–12 is amended by adding a Preliminary Note preceding paragraph (a); revising paragraph (a); adding paragraph (b)(5); redesignating paragraph (c) through paragraph (f) as paragraph (d) through paragraph (g); adding paragraph (c); revising newly designated paragraph (d), paragraph (e), and paragraph (f)(3); adding paragraph (f)(9) and paragraph (f)(10); and adding four sentences to the end of newly designated paragraph (g) to read as follows:

§ 240.15c2–12 Municipal securities disclosure.

Preliminary Note: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741, FR–42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

(a) *General.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a "Participating Underwriter" when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (an "Offering") unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.

* * * * *

(b) *Requirements.* * * *

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent:

(A) To each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, to each nationally recognized municipal securities information repository and to the appropriate state information depository, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

(C) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:

(*1*) Principal and interest payment delinquencies;

(*2*) Non-payment related defaults;

(*3*) Unscheduled draws on debt service reserves reflecting financial difficulties;

(*4*) Unscheduled draws on credit enhancements reflecting financial difficulties;

(*5*) Substitution of credit or liquidity providers, or their failure to perform;

(*6*) Adverse tax opinions or events affecting the tax-exempt status of the security;

(*7*) Modifications to rights of security holders;

(*8*) Bond calls;

(*9*) Defeasances;

(*10*) Release, substitution, or sale of property securing repayment of the securities;

(*11*) Rating changes; and

(D) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information, on or before the date specified in the written agreement or contract.

(ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

(A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;

(B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and

(C) Specify the date on which the annual financial information for the preceding fiscal year will be provided, and to whom it will be provided.

(iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

(c) *Recommendations.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.

(d) *Exemptions.* (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of $100,000 or more, if such securities:

(i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less; or

(iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:

(i) No obligated person will be an obligated person with respect to more than $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph (d)(1) of this section;

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

(A) Upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(iii) the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

(3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.

(4) The provisions of paragraph (c) of this section shall not apply to municipal securities:

(i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or

(ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.

(e) *Exemptive Authority.* The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

(f) *Definitions.* * * *

(3) The term *final official statement* means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

* * * * *

(9) The term *annual financial information* means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

(10) The term *obligated person* means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

* * * * *

(g) *Transitional Provision.* * * * Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; *except that* paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

Dated: November 10, 1994.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94-28448 Filed 11-16-94; 8:45 am]

BILLING CODE 8010-01-P

federal register

Thursday
November 17, 1994

Part VI

Securities and Exchange Commission

17 CFR Part 240
Confirmation of Transactions; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–34962; File No. S7–6–94]

RIN 3235–AF84

Confirmation of Transactions

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to Rule 10b–10 under the Securities Exchange Act of 1934 that will require brokers and dealers to provide customers immediate written notification of information relevant to their securities transactions. Consistent with the Commission's investor protection mandate and in keeping with innovations in securities products and markets, the amendments will require brokers and dealers to provide information concerning customer transaction costs in specified NASDAQ and exchange-listed securities, the status of certain unrated debt securities, the status of certain non-SIPC member broker-dealers, and the availability of information regarding asset-backed securities.

EFFECTIVE DATE: April 3, 1995.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel, C. Dirk Peterson, Senior Counsel, or Terry R. Young, Attorney (202/942–0073), Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 7–10, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary

A. Price Transparency

During the past year, the Commission has initiated efforts to further improve the efficiency of, and to protect investors in, the municipal securities and other debt markets. In September 1993, the Commission's Division of Market Regulation published the *Staff Report on the Municipal Securities Market* ("Staff Report"),[1] which contained several recommendations to improve the municipal securities market. The Staff Report recommended, among other things, riskless principal mark-up disclosure as a means of providing greater information to investors purchasing municipal securities.[2] The Staff Report noted that, unlike the equity markets where mark-ups and mark-downs[3] are disclosed to investors in non-market maker riskless principal transactions and principal transactions in "reported securities,"[4] mark-ups are not disclosed in any principal transaction in municipal securities.[5] Thus, investors of municipal securities are constrained in their ability to compare transaction costs among broker-dealers and across markets. The Staff Report identified this ability as one of the benefits of mark-up disclosure.[6]

In addition to enhanced confirmation disclosure, the Staff Report discussed the overall benefits of price transparency and the need for greater transparency in the municipal securities market.[7] Notably, price transparency enhances market liquidity and depth, and fosters investor confidence,[8] while a lack of price information impairs market pricing mechanisms, weakens competition, and prevents investors from monitoring the quality of their executions.[9]

To address some of the recommendations contained in the Staff Report, on March 9, 1994, the Commission issued for comment proposed Rule 15c2–13 under the Securities Exchange Act of 1934 ("Exchange Act")[10] to require disclosure of mark-ups in riskless principal transactions in municipal securities. Because the same benefits of mark-up disclosure apply to other debt transactions, the Commission proposed amendments to Rule 10b–10 ("Rule") under the Exchange Act that would require riskless principal mark-up disclosure for debt securities other than municipal securities.[11]

Since the Proposing Release was issued for comment on March 9, 1994, municipal market participants have proposed significant new ways of making pricing information more widely available to investors. The Municipal Securities Rulemaking Board ("MSRB") has taken the first step toward a system that will make publicly available price information for municipal securities transactions on a next day basis. Recently, the MSRB stated that its "ultimate goal for the [transparency] program is to collect and make available transaction information in a comprehensive and contemporaneous manner (footnote omitted) * * * [and] wishe[d] to reiterate to the Commission its commitment to these goals."[12] The Public Securities Association ("PSA") also has proposed a system to publicize municipal securities price information. These proposals will create the infrastructure necessary to enhance transparency in the market, and when fully implemented, will provide last sale reporting for virtually all municipal securities transactions.

The Commission is encouraged by these developments, and after careful consideration, has determined to defer the riskless principal mark-up proposal for six months[13] in anticipation of meaningful progress by the industry toward enhanced price transparency in the municipal securities market. The riskless principal mark-up proposals would provide better information only to a certain segment of transactions in the debt markets. The industry's efforts to improve transparency, on the other hand, ultimately will result in enhanced price disclosure for *all* transactions. Moreover, better dissemination of price information will benefit investors by providing them with useful information at the time they are making their investment decision, rather than after-the-fact when the confirmation is received. If, at the end of the six-month

[1] *Staff Report on the Municipal Securities Market* (September 1993).

[2] Staff Report, at 16 and 18.

[3] For purposes of this release, references to mark-ups also will apply to mark-downs or commission equivalents.

[4] *See infra* note 71 for a discussion of "reported securities."

[5] Staff Report, at 15–16.

[6] *Id.* at 16.

[7] Staff Report, at 20 and 36.

[8] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning International Markets and Individuals Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 28, 1994.

[9] *See* Brandon Becker, Director, Division of Market Regulation, Address at 19th International Organization of Securities Commissions Annual Conference (1994).

[10] Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767 ("Proposing Release").

[11] The Commission previously proposed disclosure requirements of mark-ups in riskless principal transactions on three other occasions. *See* Securities Exchange Act Release No. 15220 (Oct. 6, 1978), 43 FR 47538 (proposing mark-up disclosure for riskless principal transactions in municipal securities); Securities Exchange Act Release No. 13661 (June 23, 1977), 42 FR 33348 (proposing mark-up disclosure by non-market makers in riskless principal equity and debt securities, but not municipal securities); and Securities Exchange Act Release No. 12806 (Sept. 16, 1976), 41 FR 41432 (proposing mark-up disclosure by non-market makers in riskless principal transactions involving equity and debt securities).

[12] Letter from Robert H. Drysdale, Chairman, MSRB, to Arthur Levitt, Chairman, SEC (Nov. 3, 1994), at pp. 1–2. Available in Public Reference File No. S7–6–94.

[13] Recently, the MSRB set forth a tentative schedule for the completion of each of the four phases of its proposal: phase one (inter-dealer transactions, January 1, 1995); phase two (addition of time of trade and institutional customer transactions, December 1995); phase three (addition of retail customer transactions, November 1996); and phase four (more contemporaneous trade reporting, April 1997). *See* Letter from Robert H. Drysdale, Chairman, MSRB, to Arthur Levitt, Chairman, SEC, (Nov. 3, 1994), at pp. 3–7. Available in Public Reference File No. S7–6–94.

period, industry initiatives to improve price transparency have not progressed to the Commission's satisfaction, however, the Commission may reconsider the riskless principal mark-up proposal in light of existing alternatives.

B. Other Disclosures

In addition to the riskless principal mark-up proposals, the Commission proposed several other amendments designed to improve confirmation disclosure so that customers can better evaluate their securities transactions. Specifically, the Commission proposed amendments to Rule 10b–10 that would require broker-dealers to disclose (1) mark-ups in connection with transactions in certain NASDAQ and regional exchange-listed securities; (2) if they are not members of the Securities Investor Protection Corporation ("SIPC"); (3) information relevant to certain types of collateralized debt instruments; and (4) if a debt security has not been rated by a nationally recognized statistical rating organization ("NRSRO"). Proposed Rule 15c2–13 contained a similar provision requiring broker-dealers to disclose the unrated status of a municipal security.

The Commission also requested comment on the broader issue of whether the shortened settlement period of three days ("T+3 Settlement") will have an effect on the future utility of the confirmation and whether some information currently required in the confirmation could be shifted to an account statement.[14] In addition, the Commission proposed adding a preliminary statement to Rule 10b–10 designed to clarify that the Rule is not intended as a safe harbor from the general antifraud provisions of the federal securities laws.[15]

In response to the request for comment, the Commission received 344 comment letters, the majority of which addressed the mark-up disclosure proposals for riskless principal transactions. Commenters included regional and national broker-dealers, industry associations, financial institutions, law firms, insurance companies, and individual investors.[16] The comments presented a range of views with respect to the proposals and the effects that the proposed disclosure requirements may have on broker-dealers, investors, and markets.

After a review of the comments, the Commission is adopting the proposed amendments to Rule 10b–10 that require disclosure if a debt security is not rated by an NRSRO, with a modification to exclude all government securities from the disclosure requirement; mark-up disclosure in connection with transactions in certain NASDAQ and regional exchange-listed securities; disclosure if a broker-dealer is not a member of SIPC, except for certain transactions in investment company shares by non-SIPC member firms that do not handle customer funds or securities; and disclosure with respect to the availability of information with respect to transactions in collateralized debt securities. The Commission also is adopting the preliminary note to Rule 10b–10. To allow firms the appropriate time to adapt their systems to accommodate these disclosure requirements, the proposals will become effective April 3, 1995.

In addition, that portion of Rule 15c2–13 that would require disclosure if a municipal security was not rated by an NRSRO has been deferred and will be withdrawn if the MSRB acts to adopt similar amendments to its confirmation rule, Rule G–15.[17] The MSRB recently reiterated its willingness to amend Rule G–15 to require disclosure if a municipal security is not rated by an NRSRO.[18]

II. Description of Amendments

A. Role of the Confirmation

The Commission's confirmation rule, Rule 10b–10 [19] under the Exchange Act,[20] generally requires a broker-dealer effecting a customer transaction in securities (other than U.S. Savings Bonds or municipal securities) to provide written notification to its customer, at or before completion of a transaction, that discloses information specific to the transaction. The confirmation requires, among other things, the disclosure of: The date, time, identity, and number of shares bought or sold;[21] the capacity of the broker-dealer;[22] the net dollar price and yield of a debt security;[23] and, under specified circumstances, the amount of compensation paid to the broker-dealer and whether payment for order flow is received.[24] For over 50 years, the customer confirmation has served basic investor protection functions by conveying information allowing investors to verify the terms of their transactions; alerting investors to potential conflicts of interest with their broker-dealers; acting as a safeguard against fraud; and providing investors the means to evaluate the costs of their transactions and the quality of their broker-dealer's execution.

1. T+3 Settlement

In the Proposing Release, the Commission requested comment on the future utility of the confirmation once T+3 Settlement is implemented on June 7, 1995.[25] Rule 10b–10 requires that a confirmation be sent at or before completion of a customer transaction.[26] Commenters noted that T+3 Settlement will diminish the confirmation's usefulness as a customer invoice and questioned the practicability of requiring the disclosure of additional information on a document that an investor will receive after already having made his or her investment decision and tendering funds or securities.[27]

Notwithstanding the shortened settlement period of T+3 and the possibility that an investor may receive the confirmation after payment has been made, the Commission believes that the confirmation will continue to serve important investor protection functions. T+3 Settlement's implementation merely may mean that the confirmation may take on a different role. Some firms may continue to use the confirmation as

---

[14] *See* Proposing Release, *supra* note 10, at 59 FR 12767–68.

[15] *Id.* at 59 FR 12772.

[16] The comment letters and a summary of comments have been placed in Public Reference File No. S7–6–94, which is available for inspection in the Public Reference Room.

[17] MSRB Rule G–15, MSRB Manual (CCH) ¶ 3571.

[18] Letter from Robert H. Drysdale, Chairman, MSRB, to Arthur Levitt, Chairman, SEC (Nov. 3, 1994). Available in Public Reference File No. S7–6–94.

[19] 17 CFR 240.10b–10.

[20] 15 U.S.C. 78a *et seq.*

[21] 17 CFR 240.10b–10(a)(2).

[22] 17 CFR 240.10b–10(a)(1).

[23] 17 CFR 240.10b–10(a)(4)(i); and 17 CFR 240.10b–10(a)(5).

[24] 17 CFR 240.10b–10(a)(7) (ii) and (iii); 17 CFR 240.10b–10(a)(8)(i)(A); and 17 CFR 240.10b–10(a)(8)(i)(B).

Recently, the Commission proposed for comment additional disclosures relevant to payment for order flow, which would include for monetary payment for order flow, the range of payments received on a per share basis and on an aggregate basis annually. For non-monetary payment for order flow, the Commission proposed requiring disclosure of an estimate of the range of payment for order flow on a per share basis and on an aggregate basis annually. *See* Securities Exchange Act Release No. 34903 (Oct. 27, 1994), 59 FR 55014.

[25] T+3 Settlement was adopted in Securities Exchange Act Release No. 33023 (Oct. 6, 1993), 58 FR 52891.

[26] Rule 15c1–1 under the Exchange Act defines "the completion of the transaction." 17 CFR 240.15c1–1(b).

[27] *See, e.g.,* Letters from A. George Saks, Executive Vice President, Secretary, and General Counsel, Smith Barney (Aug. 1, 1994); Robert M. Sweeney, Vice President/Assistant Comptroller, Gibraltar Securities Co. (June 14, 1994); William J. Jester, Jr., Chemical Banking Corp. (June 14, 1994); and Kurt D. Halvorson, Vice President & Controller, AmeriTrade (May 27, 1994), to Jonathan G. Katz, Secretary, SEC.

a customer invoice, while financing positions when customer payment is received after settlement date. For other firms, the confirmation may not continue to serve in all circumstances as an invoice of a transaction because ordinary confirmation delivery and transfer of customer funds and securities may not be feasible within a three-day settlement cycle.[28] Rather, the confirmation may serve primarily as written evidence of the contract between the customer and broker-dealer.[29] As a written record of the transaction, the confirmation will continue to provide investors the necessary information to assist them in evaluating the quality and accuracy of their trades while assisting them in correcting mistakes and verifying the terms of their transactions. Accordingly, while T+3 Settlement may affect the mechanics of settlement, it will not eliminate the confirmation's investor protection functions.

2. Periodic Account Statement

The Commission also requested comment on the feasibility of transferring information currently disclosed on the confirmation to a periodic account statement.[30] Many commenters addressing this issue opposed such a use of the periodic account statement and noted that it was not the appropriate document to convey particularized trade information.[31] Rather, as one commenter indicated, account statements are intended to summarize the activity and status of an account; they are not intended to convey information regarding the features and risks of each individual securities transaction.[32] Other commenters, however, noted that, as investors increasingly rely upon periodic account statements, the confirmation will diminish as a primary disclosure device.[33] At this time, the Commission has determined to retain the confirmation as the basic transaction disclosure document and use the account statement, the account opening document, or annual disclosure requirements as needed to supplement or summarize confirmation disclosures.

The Commission noted in the Proposing Release, however, that a customer may waive the receipt of an immediate confirmation in the context where a fiduciary has discretion over the customer's account.[34] The Commission noted that, in its view, the account, rather than the fiduciary, was the customer for purposes of Rule 10b–10. To effect a valid waiver, the broker-dealer must (1) obtain from the customer a written agreement that the fiduciary receive the immediate confirmation; and (2) send to the customer a periodic report, not less frequently than quarterly, containing the same information that would have been contained in an immediate confirmation.[35] The customer may not waive this periodic report.[36]

The requirement to send a periodic report is intended to ensure that the *beneficial owner* of the account receives material information needed to verify the transaction in the account.[37] As the

[28] One commenter suggested that the Commission reevaluate the meaning of "give or send" under Rule 10b–10 in light of T+3 Settlement and current technology, such as electronic messaging, E-mail, direct computer links, telefax, and fax modems. *See* Letter from Sullivan & Cromwell, to Jonathan G. Katz, Secretary, SEC (July 15, 1994).

In the Proposing Release, the Commission recognized the use of a facsimile machine to send customer confirmations. *See* Proposing Release, *supra* note 10, at 59 FR 12767 n.5. To the extent that a customer has a facsimile machine, a broker-dealer would fulfill its confirmation delivery obligation if it sent the confirmation via facsimile transmission. The staff also has allowed, under specified conditions, confirmations to be sent by other electronic means. *See Letter regarding Thomson Financial Services, Inc.* (Oct. 8, 1993).

The Commission agrees that T+3 Settlement may encourage alternatives to the mail system for sending confirmations and that a flexible approach may be necessary to accommodate T+3 Settlement with existing technology. The Commission, however, believes that each approach should be viewed on a case-by-case basis, as has been previous practice, to ensure the safety and reliability of the confirmation transmission.

[29] Under the current text of the Uniform Commercial Code, the confirmation serves as a written record of the transaction, thus satisfying the statute of frauds. Uniform Commercial Code Section 8–319 states that a "contract for the sale of securities is not enforceable by way of action or defense unless * * * there is some writing signed by the party against whom enforcement is sought or by his authorized agent or broker, sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price." A confirmation, bearing the broker-dealer's letterhead or some other identifying marking, generally fulfills that requirement. Revised Article 8 of the Uniform Commercial Code, which was endorsed recently by both the American Law Institute and the National Conference of Commissioners on Uniform State Laws, would omit current Section 8–319. Due to the prior difficulties in applying Section 8–319 to the sale of securities over the telephone and the more common use of electronic means for securities transactions, proposed Section 8–113 states that "[a] contract or modification for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making."

[30] See Proposing Release, *supra* note 10, at 59 FR 12768.

[31] *See, e.g.*, Letters from A. George Saks, Executive Vice President, Secretary, and General Counsel, Smith Barney (Aug. 1, 1994); Barry H. Zucker, President & CEO, J.B. Hanauer & Co. (June 20, 1994); and Jon S. Corzine, Goldman, Sachs & Co. (June 15, 1994), to Jonathan G. Katz, Secretary, SEC.

[32] *See, e.g.*, Letter from Donald E. Walter, Compliance Director/Principal, Edward D. Jones & Co., to Jonathan G. Katz, Secretary, SEC (July 15, 1994). Another commenter noted that transferring confirmation information to an account statement may clutter the account statement and make it less readable. *See* Letter from Barry H. Zucker, President & CEO, J.B. Hanauer & Co., to Jonathan G. Katz, Secretary, SEC (June 20, 1994).

[33] *See, e.g.*, Letters from Robert M. Sweeney, Vice President/Assistant Comptroller, Gibraltar Securities Co. (June 14, 1994); William J. Jester, Jr., Chemical Banking Corp. (June 14, 1994); and Kurt Halvorson, Vice President & Comptroller, AmeriTrade (May 27, 1994), to Jonathan G. Katz, Secretary, SEC.

[34] *See* Proposing Release, *supra* note 10, at 59 FR 12767 n.3.

[35] To satisfy this requirement, a broker-dealer may deliver, directly to its customer, duplicate confirmations representing each of the customer's transactions for the prior period, together with the customer's account statement. This procedure would allow investors to rely on the account statement to monitor their accounts, while referring to the confirmation for the details of each specific trade. Investors already look to old confirmations for details which are not present on the account statement, and this procedure would allow investors to continue to rely on their confirmations and their account statements in substantially the same way.

[36] Some concerns have been raised with respect to the application of this policy and its relationship with Rule 409 of the New York Stock Exchange ("NYSE"). *See, e.g.*, letter from Kevin J. Mackay, President/Compliance and Legal Division, Securities Industry Association ("SIA"), to Jonathan G. Katz, Secretary, SEC (July 22, 1994). Specifically, Rule 409(b) permits NYSE member firms to send a confirmation to a *non-member* person holding power of attorney over a customer account if "either (A) the customer has instructed the member organization in writing to send such confirmations, statements, or other communications in care of such person, or (B) duplicate copies are sent to the customer at some other address designated in writing by him." NYSE Rule 409, 2 NYSE Guide (CCH) ¶ 2409.

Under the Commission's position articulated above, a customer who waived receipt of the immediate confirmation would receive more information with his quarterly account statement than that currently required under NYSE Rule 409. To the extent the rules of the NYSE, or any self-regulatory organization, conflict with the Commission's stated policy, the more restrictive requirement would govern. Thus, a NYSE member wishing to take advantage of a waiver would be required to adhere to these Commission requirements in addition to any obligations imposed by Rule 409.

The SIA argued that this position would (1) lead to duplicative efforts on the part of broker-dealers because broker-dealers already will have sent trade information to the fiduciary in an immediate confirmation; (2) depart from standard industry practice; and (3) require expensive system changes to comply with the position. The Commission emphasizes that this substitution of quarterly statements for the immediate confirmation is optional. No broker-dealer is required in the first instance to include all relevant trade information in a quarterly statement; however, if the broker-dealer, with the written authorization of the customer, wishes to omit sending the customer an immediate confirmation and instead send it to the account fiduciary, then the requirements of written instructions from the customer and a non-waiveable periodic report, as described above, must be satisfied in order to effect a valid waiver. These requirements are necessary to allow investors to monitor their accounts in the absence of a transaction-by-transaction report in the confirmation.

[37] The requirement to send a periodic report to the customer, if the customer has requested in

Commission noted in the release originally adopting Rule 10b–10, the Rule is not intended to require a broker-dealer dealing with the trustee of a plan to deliver statements to plan participants where the trustee is the shareholder of record of the securities being purchased or sold. In those instances, the Rule would require the broker-dealer to deliver a confirmation, or upon written request, a periodic report, only to the trustee.[38] A beneficiary of the trust would be required to receive an immediate confirmation, or upon written request, the periodic report, only if that beneficiary was a beneficial owner of the trust assets on the books of the broker-dealer, enjoying the rights and privileges of beneficial ownership.

The Commission also believes that the broker-dealer can satisfy its obligation to send a confirmation to the customer if it sends the confirmation to a custodian of the customer authorized to receive securities and disburse funds for the customer.[39] The custodian in question must not be affiliated with a broker-dealer or an investment adviser or have any role in choosing the broker-dealer or investment adviser used;[40] and the customer must retain the right to request that the confirmation be sent directly to the customer, at no extra charge by the custodian or broker-dealer. Moreover, an account custodian may not choose to receive a periodic report in place of an immediate confirmation.

3. Preliminary Note

The Commission proposed adding a preliminary note to Rule 10b–10 clarifying that the Rule is not intended as a safe harbor from disclosure obligations imposed by the general antifraud provisions of the federal securities laws.[41] This note is intended to respond to claims made by litigants that Rule 10b–10 prescribes all the necessary disclosure relevant to a customer's securities transaction.[42] A few commenters addressed the inclusion of the preliminary note to Rule 10b–10, with equal support for[43] and opposition to[44] the note. One supporter suggested that the Commission could accomplish the same purpose of clarification in an interpretative release.[45] One opponent of the preliminary note argued that its existence would lead to frivolous claims against broker-dealers.[46]

After reviewing the comments, the Commission is adopting the preliminary note to Rule 10b–10. The Commission is not persuaded that the existence of the preliminary note would lead to any additional litigation against broker-dealers. The preliminary note is merely making explicit a longstanding position that the antifraud provisions of the federal securities laws may impose, given the circumstances, greater disclosure than what may be required by a specific rule or regulation.[47]

B. Mark-Up and Mark-Downs in Riskless Principal Transactions in Debt Securities

The majority of comment letters addressed the proposed amendments to Rule 10b–10 and the portion of proposed Rule 15c2–13 that would require mark-up disclosure of riskless principal trades in debt securities.[48] Generally, most commenters opposed the proposals on the grounds that the requirements would have detrimental effects on competition and market liquidity; would cause compliance difficulties; would create customer confusion; and are not based upon findings of abusive practices in the debt market.

It has been argued by some commenters that greater price transparency in the municipal market could achieve similar goals as riskless principal mark-up disclosure without the alleged negative effects purported to result from mark-up disclosure.[49] Since the proposals were published for comment in March, progress has been made to develop price transparency in the debt markets. In particular, the MSRB has proposed a program that ultimately would provide same day price reporting of all transactions in municipal securities, including same day reporting of retail trades. This program is to be implemented in four phases. As proposed, the first phase of the MSRB program will collect reports of interdealer transactions and make available to the public daily high-low and average price figures for the most frequently traded issues (initially defined as those trading at least four times during the day).[50] These

---

writing that the immediate confirmation be sent to the customer's fiduciary, applies only if the broker-dealer has an existing duty under Rule 10b–10 to send an immediate confirmation directly to the customer in the absence of such a written request. This requirement therefore would not apply to paragraph 10b–10(b), which governs purchases and sales of securities in a money market fund, as defined in newly amended paragraph 10b–10(b)(1), a periodic plan, as defined in paragraph 10b–10(d)(5), and an investment company plan, as defined in paragraph 10b–10(d)(6). Paragraph (b) of Rule 10b–10 permits, upon written request of the customer, written statements containing the information specified in that paragraph to be sent not less frequently than quarterly, directly to the customer or some other person designated by the customer for distribution to the customer.

Because there are circumstances, not enumerated specifically in Rule 10b–10, that would make compliance with the rule unduly burdensome, paragraph 10b–10(f) authorizes the Commission to exempt broker-dealers from the rule's requirements with regard to specific transactions or specific classes of transactions for which the broker or dealer will provide alternative procedures to effect the purposes of Rule 10b–10. This authority has been delegated to the Division of Market Regulation. 17 CFR 200.30–3(a)(32).

[38] Securities Exchange Act Release No. 13508 (May 5, 1977), at n.24.

[39] The custodian must not hold itself out as a broker-dealer or an investment adviser. *But see* Investment Advisers Act Release No. 1406 (March 16, 1994), 59 FR 13464 (proposing a rule to require investment advisers to ensure that custodians of investment adviser client accounts provide the client or its designee with account statements not less than quarterly).

[40] Securities orders must be placed by the customer or the customer's investment adviser, not the custodian.

[41] *See* Proposing Release, *supra* note 10, at 59 FR 12772.

[42] *See, e.g.*, Shivangi v. Dean Witter Reynolds, Inc., 637 F. Supp. 1001 (S.D. Miss. 1986), *aff'd*, 825 F.2d 885 (5th Cir. 1987); Krome v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 637 F. Supp. 910, 915–16 (S.D.N.Y. 1986); and Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Fed. Sec. L. Rep. (CCH) ¶ 93,102 (E.D. Pa. 1986), *rev'd*, 835 F.2d 1031 (3d Cir. 1987).

[43] *See, e.g.*, Letters from Donald E. Walter, Compliance Director/Principal, Edward D. Jones & Co. (July 11, 1993); and Douglas L. Kelly, Director/Law & Compliance Division, A.G. Edwards & Sons, Inc. (June 13, 1994), to Jonathan G. Katz, Secretary, SEC.

[44] *See, e.g.*, Letters from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Incorporated (July 14, 1994); and Jeffrey Rubin, President, InterCapital Assets, Inc. (June 13, 1994), to Jonathan G. Katz, Secretary, SEC.

[45] Letter from Douglas L. Kelly, Director/Law & Compliance Division, A.G. Edwards & Sons, Inc., to Jonathan G. Katz, Secretary, SEC (June 13, 1994). This commenter also suggested that if a note were added to Rule 10b–10, a similar note also should precede Rule 15c2–13. At this time, the Commission is not adopting Rule 15c2–13.

[46] Letter from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Incorporated, to Jonathan G. Katz, Secretary, SEC (July 14, 1994).

[47] *See supra* note 42. One commenter argued that the preliminary note provides no useful guidance because the Commission has not articulated a set of guidelines concerning disclosure requirements in addition to those required in a prospectus and under the Exchange Act. *See* Letter from Sullivan & Cromwell, to Jonathan G. Katz, Secretary, SEC (July 15, 1994), at pp. 2–3.

The Commission does not intend to specify key disclosure items under the antifraud provisions of the federal securities laws. Each circumstance is different and determining the materiality of any particular item of disclosure depends on the facts and circumstances of each case.

[48] Of the 344 comment letters received, 313 addressed the mark-up disclosure proposals.

[49] *See, e.g.*, Letters from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Incorporated (July 14, 1994); James D. McKinney, Partner and Manager of Fixed Income Dept., William Blair & Company (July 13, 1994); Thomas W. Masterson, Chairman, Masterson Moreland Sauer Whisman, Inc. (July 13, 1994); G. Frederick Kasten, Jr., President and Chief Executive Officer, Robert W. Baird & Co., Incorporated (June 15, 1994); and Rauscher Pierce Refnes, Inc. (June 14, 1994), to Jonathan G. Katz, Secretary, SEC.

[50] To implement phase one, the MSRB, pursuant to Rule 19b–4 of the Exchange Act, has filed with the Commission a proposed rule change to amend Rule G–14 of the MSRB Rules, which, once

Continued

requirements will be expanded in phase two to include institutional customer transactions. The third phase will expand the daily reporting requirements to include retail customer transactions, and phase four will advance reporting times closer in time to the transaction, such as by the end of day or within a specified time period following the trade. In the initial phases of the MSRB's proposal, information regarding the prices and volume of transactions in approximately 80 to 240 issues would be reported each day. As each phase is implemented, the MSRB will review closely this information and system operations, with a view toward reflecting a greater number of issues and transactions in the reports.

In addition to the proposal by the MSRB, the PSA has proposed two initiatives to convey municipal securities pricing information to retail investors. First, the PSA proposes to develop a generic scale and yield curve for AAA-insured revenue bonds. This information, which will be made available to daily newspapers, is intended to provide customers with grade information on the price and yield of a representative range of bonds. Second, the PSA proposes to establish a 900-number which investors could call to obtain price information regarding particular municipal securities.

Although the MSRB's initiative is in a developmental stage, the Commission believes it ultimately could provide the public with improved information about the price of municipal securities. If widely published, this information would allow investors to better assess the prices provided by their broker-dealers in a municipal securities trade. In light of these proposals, the Commission has decided to defer for a period of six months adoption of that part of Rule 15c2–13 requiring the disclosure of mark-ups for riskless principal transactions in municipal securities.

The Commission has deferred adoption of the riskless principal mark-up disclosure proposal in order to ascertain whether the proposed price information systems can provide more meaningful benefits to investors in the long-term and to assess the progress of the industry in developing the proposed systems. Price transparency, if fully developed, will provide better market information to investors on a timely basis (*e.g.*, before the transaction). Potentially, price transparency also could provide investors the ability to determine the value of their municipal securities purchased in principal transactions. The proposed mark-up disclosure, on the other hand, would have provided cost information to investors only in riskless principal transactions and would not have applied to other principal transactions, the majority of transactions in the debt market. Price transparency, if fully developed, meets investors' need for information without focusing on only one portion of the market, which commenters argued could lead to a deleterious restructuring of the market, thus reducing market liquidity and narrowing the available choices of securities sold to customers.[51]

The Commission recognizes that these benefits depend on the sound design and successful implementation of transparency proposals. Their value to investors further depends on widespread availability of the information, and customer understanding of how it should be used. At the end of six months, the Commission will assess the need for further action based upon the prospects for the availability of meaningful pricing information to a broad range of investors about a full range of securities. If such information is not likely to be available, the Commission will explore alternatives to better provide information to fixed income investors. To this end, the Commission similarly is deferring the proposed amendment to Rule 10b–10 requiring mark-up disclosure for other debt securities. While the Commission believes it is appropriate to address transparency in municipal securities initially because of the presence of a large proportion of individual investors in that market, during the deferral, the Commission expects the industry to address the extent to which customer price information can be increased in debt markets other than the municipal securities market. The Commission recognizes that the government, corporate, and mortgage securities markets have different levels of price information publicly available. For example, GovPx, a joint venture of primary dealers and interdealer brokers formed in 1990, provides to investors real-time quotations, trade prices, and volume information for U.S. Treasury and other government securities via a worldwide network of 12,000 terminals. In addition, the National Association of Securities Dealers, Inc. ("NASD") developed the Fixed Income Pricing System ("FIPS"), which collects, processes, and disseminates real-time firm quotations for 30 to 50 of the most liquid, high yield bonds traded in the over-the-counter market.[52] The Commission expects the industry to review the availability of information to investors in each of these markets and consider methods of increasing transparency as an alternative to riskless principal disclosure in these markets.

Even though the Commission is deferring the adoption of riskless principal mark-up disclosure, the Commission continues to believe that, absent transparency in the debt markets, the disclosure of the dealer's cost along with the mark-up would be of use to customers in assessing the value of their debt securities. In the absence of progress on transparency, the Commission will revisit its riskless principal proposal. The Commission also may consider whether to require the disclosure of all mark-ups in principal transactions based on the underlying inventory costs,[53] or the prevailing market price[54] or to mandate alternative price transparency systems.

The Commission strongly believes that real progress is needed in a timely fashion to achieve the goal of better customer information for market prices in the debt market. Achievement of this goal will add strength to and confidence in the debt markets, to the benefit of both broker-dealers and investors.

C. Disclosure of Unrated Securities

The Commission also published for comment a requirement to disclose, if applicable, that certain debt securities have not been rated by an NRSRO.[55] The proposal excluded government securities defined under Section 3(a)(42)(A) and (B) of the Exchange Act,[56] but

approved, will require the reporting of interdealer municipal securities transactions to a designee (*e.g.*, the National Securities Clearing Corporation) for compilation in a daily report and for use by regulators.

[51] *See, e.g.*, Letters from Philip T. Colton, Maun & Simon (June 14, 1994); Lawrence T. Lewis, III, Managing Director, Clark Melvin Securities Corporation (June 8, 1994); and Adam Crews, President/Chief Executive Officer, Crews & Associates, Inc. (June 1, 1994), to Jonathan G. Katz, Secretary, SEC.

[52] *See* Securities Exchange Act Release No. 32019 (March 19, 1993), 58 FR 16428 for a discussion of the order approval allowing the NASD to implement FIPS.

[53] To comply with this disclosure, broker-dealers would have to assign a value to a security bought into inventory on either a last in, first out or first in, first out accounting basis.

[54] *See* 17 CFR 240.15g–4 and Securities Exchange Act Release No. 30608 (April 13, 1992), 57 FR 19022 for a discussion of compensation disclosure requirements for transactions in penny stocks.

[55] *See* Proposing Release, *supra* note 10, at 59 FR 12770.

[56] Securities exempt from the proposed rating disclosure would include (1) securities that are direct obligations of the U.S., or in which the U.S. has guaranteed the principal or interest; or (2) securities which are issued or guaranteed by corporations in which the U.S. has a direct or indirect interest and which the Secretary of

requested specific comment on whether other securities should be excluded from this disclosure.[57] In addition, specific comment was requested whether the MSRB should implement the disclosure requirement with respect to municipal securities, rather than the Commission.[58]

Of the 43 commenters that addressed this disclosure proposal, 24 supported the proposal.[59] Some commenters believed that the disclosure requirement did not go far enough and indicated that specific ratings also should be disclosed on the confirmation.[60] In particular, commenters believed that the confirmation should bear all ratings of securities, particularly those rated below investment grade.[61]

Ten commenters opposed the disclosure requirement on the grounds that requiring this disclosure may be unhelpful to investors. They argued that such disclosure may cause investors to believe that unrated securities are inferior to rated securities, when the unrated security may pose less risk than a rated security, particularly a security rated below investment grade.[62] They noted that such disclosure does not explain the reasons why a security may not have a credit rating—notably that smaller, but no less sound, issuers may not wish to bear the expense of obtaining a credit rating.[63] Commenters also questioned why the Commission excluded from the disclosure requirement only government securities defined under Section 3(a)(42)(A) and (B) of the Exchange Act.[64] In particular, Freddie Mac argued that securities issued by government sponsored enterprises ("GSEs"), including those issued by Freddie Mac, also should be excluded from the disclosure requirement. Freddie Mac argued that, because of the market's assessment of the creditworthiness of GSEs, it makes little economic sense for a GSE to bolster its creditworthiness with an independent rating.[65] Finally, some commenters believed that the MSRB should adopt any rule affecting the municipal securities market; other commenters were neutral whether the Commission or the MSRB implemented rulemaking.

After considering the comments, the Commission is adopting the proposed amendments to Rule 10b-10 requiring disclosure if a debt security, other than a government security, has not been rated by an NRSRO. Such disclosure would be more meaningful to the investor if it is made together with the description of the security. As noted in the Proposing Release, this disclosure is not intended to suggest that an unrated security is inherently riskier than a rated security.[66] Rather, the disclosure is intended to alert customers that they may wish to obtain further information or clarification from their broker-dealers. In most cases, this disclosure should verify information that was disclosed to the investor prior to the transaction. If a customer was not previously informed of the security's unrated status, then confirmation disclosure may prompt a dialogue between the customer and broker-dealer.

The Commission agrees with commenters that all "government securities" should be excluded from the unrated debt disclosure requirement, not just those defined under Section 3(a)(42)(A) and (B) of the Exchange Act.[67] Therefore, government securities meeting the definition under sub-paragraphs (C) and (D) of Section 3(a)(42), which includes securities issued by GSEs, will be exempt from the disclosure requirement. The Commission, however, does not intend to expand the class of securities subject to the exclusion beyond those defined as government securities in Section 3(a)(42).

The non-rated debt proposal for municipal securities was contained in proposed Rule 15c2–13. In its comment letter, the MSRB stated that, "[t]he Board agrees with the Commission that, while the fact that a bond is unrated is not necessarily indicative of problems, disclosure of the fact would be helpful to investors."[68] The MSRB also noted that, if the Commission determined that such information was needed by investors in debt securities, it would amend its confirmation rule, Rule G–15, and require disclosure if a municipal security has not been rated by an NRSRO.[69] Inasmuch as other confirmation requirements for municipal securities are currently set forth in Rule G–15 of the MSRB, the Commission is willing to defer this portion of the proposal to allow the MSRB to adopt the requirement as part of its rules, and will withdraw it after the MSRB has taken action.

D. Disclosure of Mark-Ups and Mark-Downs in Certain NASDAQ and Exchange-Listed Securities

As part of the amendments to Rule 10b-10, the Commission proposed requiring the disclosure of mark-up information for principal transactions in

---

Treasury has designated for exemption. 15 U.S.C. 78c(a)(42)(A) and (B).

[57] Proposing Release, *supra* note 10, at 59 FR 12770.

[58] *Id.*

[59] *See, e.g.*, Letters from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Incorporated (July 14, 1994); David C. Clapp, Chairman, MSRB (June 15, 1994); and Douglas L. Kelly, Director, Law and Compliance, A.G. Edwards & Sons, Inc. (June 13, 1994), to Jonathan G. Katz, Secretary, SEC.

Alex. Brown & Sons, Incorporated sought clarification that a bond rated by a single NRSRO, but not necessarily other NRSROs, nonetheless would be excluded from the disclosure requirement. (Letter from A.B. Krongard, Chief Executive Officer, Alex. Brown, to Jonathan G. Katz, Secretary, SEC (July 14, 1994), at p.6). The rule language states that a broker-dealer would be required to disclose when a security was not rated by an NRSRO. Accordingly, if a single NRSRO has rated a security, then it follows that no disclosure would be required.

[60] *See, e.g.*, Letters from Grant T. Callery, Vice President/General Counsel, NASD (July 26, 1994); and Robert Reeves, Sr. Vice President, Ferris Baker Watts, Incorporated (June 14, 1994), to Jonathan G. Katz, Secretary, SEC.

[61] One commenter argued that disclosure of ratings, and in particular ratings below investment grade, would better assist investors in comparing an unrated security that may be of a high credit quality with one that, while rated, may be of lesser credit quality. *See* Letter from James H. Morgan, President/Chief Operating Officer, Interstate/Johnson Lane, to Jonathan G. Katz, Secretary, SEC (June 14, 1994). The Commission will revisit the issue of whether Rule 10b-10 should require the disclosure of ratings for corporate debt securities once commenters have responded to a recent Commission proposal addressing the feasibility of disclosing ratings in a prospectus. See Securities Act Release No. 7086, (Aug. 31, 1994), 59 FR 46304.

[62] *See, e.g.*, Letters from Sullivan & Cromwell (July 15, 1994); R. Fenn Putman, Chairman, PSA (June 20, 1994); and Jon S. Corzine, Goldman, Sachs & Co. (June 15, 1994), to Jonathan G. Katz, Secretary, SEC.

[63] One commenter noted that rural issuers would be harmed by the disclosure requirement because the size of a rural issue makes bearing the expense of obtaining a rating economically impractical. See Letter from Ian B. Davidson, Chairman, and Kreg A. Jones, Chief Operating Officer, D.A. Davidson & Co., to Jonathan G. Katz, Secretary, SEC (June 14, 1994).

[64] *See, e.g.*, Letter from Mitchell Delk, Vice President/Government and Industry Relations, Freddie Mac, to Jonathan G. Katz, Secretary, SEC (June 15, 1994).

[65] Freddie Mac also described the anomalous situation in which, on the one hand, GSE securities would be subject to the disclosure requirement, but on the other hand, rated private label asset-backed securities would not, even though the underlying securities were GSE securities and primarily responsible for the rating. See Letter from Mitchell Delk, Vice President/Government and Industry Relations, Freddie Mac, to Jonathan G. Katz, Secretary, SEC (June 15, 1994), at pp. 2–3.

[66] Nevertheless unrated municipal bonds, which make up approximately 33% of the market, in the aggregate have a higher default rate than do rated bonds. *See Municipal Bond Defaults—The 1980's Decade in Review* 1–2, at 1, J.J. Kenny Co., Inc. (1993). According to this study on default rates between January 1, 1980 to December 31, 1991, 628 unrated issues defaulted compared with 98 rated issues. According to data provided by the Securities Data Company, unrated debt defaults make up approximately 75% of all defaults. *See also* Public Securities Association, *An Examination of Non-Rated Municipal Defaults 1986–1991* 4 (Jan. 8, 1993).

[67] 15 U.S.C. 78c(a)(42).

[68] Letter from David C. Clapp, Chairman, MSRB, to Jonathan G. Katz, Secretary, SEC (June 15, 1994).

[69] *Id.*

certain securities quoted on NASDAQ or listed on regional exchanges.[70] This proposal covered securities that are subject to last sale reporting, but are not technically "reported securities" under Rule 11Aa3–1 of the Exchange Act.[71] As noted in the Proposing Release, the NASD adopted amendments to its confirmation rule requiring the disclosure of mark-up information in principal transactions in securities that are not NASDAQ/NMS securities—*i.e.*, NASDAQ Small Cap Securities.[72] The purpose of the proposed amendment is to consolidate disclosures already required under NASD rules. Because last sale information is available for regional exchange-listed securities, the Commission proposed to extend the disclosure requirements to those securities, in addition to Small Cap Securities. By adopting this proposal, the confirmation rule will treat all equity securities subject to last sale reporting similarly, irrespective of their trading markets.

The two comments that addressed this requirement supported the proposal.[73] Accordingly, under Rule 10b-10, broker-dealers effecting principal transactions in Small-Cap NASDAQ and regional exchange-listed securities that are subject to last-sale reporting will be required to disclose on the confirmation the reported trade price, price to the customer, and the difference, if any, between the two prices.

E. Disclosure of Coverage by the Securities Investor Protection Corporation

In order to reduce investor confusion concerning a firm's SIPC coverage,[74] the Commission proposed to amend Rule 10b–10 to require affirmative disclosure, if applicable, when a broker-dealer is not a member of SIPC and when an account is carried by a non-SIPC-member broker or dealer. Generally, the Securities Investor Protection Act of 1970 requires broker-dealers registered with the Commission under Section 15(b) of the Exchange Act to be members of SIPC. Certain types of broker-dealers registered under Section 15(b), as well as all broker-dealers registered as government securities brokers and dealers under Section 15C of the Exchange Act, are excluded from SIPC membership.[75]

Many commenters addressing this issue supported the Commission's proposal to inform customers when their broker-dealers are not SIPC members.[76] Other commenters generally agreed with requiring the disclosure, but disagreed that the confirmation was the appropriate disclosure medium and suggested that non-membership status in SIPC be disclosed in a periodic account statement or opening account document.[77] Commenters opposing the disclosure initiative argued that the disclosure would be misleading to investors in that they would believe that they are at greater risk when dealing with a non-SIPC firm.[78] The Investment Company Institute ("ICI") argued that requiring "negative disclosure" concerning the lack of SIPC coverage is contrary to the reasons certain persons are exempted from the membership requirement in the first instance—namely, excluded broker-dealers present limited risks to investors because they do not hold customer funds.[79]

The Commission, consistent with its authority under the Government Securities Act Amendments of 1993,[80] is adopting the proposed amendment to ensure that customers are not led to believe that their accounts are subject to protection beyond what actually is the case.[81] This disclosure is relevant and meaningful to investors. Further, the confirmation is the best vehicle to convey this information to customers on a transaction-specific basis, particularly in situations where a customer is dealing with affiliated broker-dealers and one or more of the affiliates is not a SIPC member.

The Commission agrees, however, that certain instances exist where this disclosure should not apply.[82] For instance, the ICI stated that in some cases when a broker-dealer contracts with an investment company for the distribution of fund shares, customers purchasing such shares will send their purchase money directly to the fund's

---

[70] *See* Proposing Release, supra note 10, 59 FR 12770.

[71] 17 CFR 240.11Aa3–1(a)(4). This provision defines "reported security" as any exchange-listed equity security or NASDAQ security for which transaction reports are made available on a real-time basis pursuant to an effective transaction reporting plan. An "effective transaction reporting plan" refers to a transaction reporting plan that the Commission has approved pursuant to Rule 11Aa3–1. 17 CFR 240.11Aa3–1(a)(3).

Reported securities currently include:

1. NASDAQ securities that meet standards set forth in the National Market System Securities Designation Plan ("NASDAQ/NMS securities).

2. Certain securities listed on a national securities exchange that meet standards of the transaction reporting plan known as the Restated Consolidated Tape Association Plan. This would include securities that are registered or admitted to unlisted trading privileges on a national securities exchange, including securities listed on various regional exchanges, and that substantially meet NYSE or American Stock Exchange, Inc. original listing criteria.

[72] NASD Schedule to By-Laws, Schedule D, pt. XI, Section 3, NASD Manual (CCH) ¶ 1867D.

[73] *See* Letters from Robert F. Price, Chairman/Federal Regulation Committee, SIA (July 15, 1994); and Kurt D. Halvorson, Vice President/Controller, AmeriTrade (May 27, 1994), to Jonathan G. Katz, Secretary, SEC.

[74] SIPC, a non-profit, membership corporation, was established under the Securities Investor Protection Act of 1970. SIPC is funded by assessments on its members and interest earned on fund assets. The fund is used to protect securities customers of SIPC-member broker-dealers that fail financially. 15 U.S.C. 78aaa *et seq.* For example, in the event of the failure of a SIPC member firm, SIPC provides protection up to $500,000 for claims for cash and securities (although claims solely for cash are limited to $100,000) of each customer. 15 U.S.C. 78fff–3(a)(1).

[75] In addition to government securities brokers and dealers, the following broker-dealers are not required to be members of SIPC: (1) Persons whose principal business in the determination of SIPC (and with Commission approval) is conducted outside the U.S.; and (2) persons whose business consists exclusively of (a) the distribution of shares of registered open-end investment companies or unit investment trusts, (b) the sale of variable annuities, (c) the business of insurance, or (d) the business of rendering investment advisory services to registered investment companies or insurance company separate accounts. 15 U.S.C. 78ccc(a)(2)(A) and 78lll(12).

[76] *See, e.g.*, Letters from Ronald S. Plaine, President, Comerica Securities (undated); David M. Beckius, Vice President/Sr. Attorney, Dean Witter Reynolds, Inc. (July 14, 1994); and William E. Kramer, Assistant Vice President, Nomura Securities International, Inc. (July 15, 1994), to Jonathan G. Katz, Secretary, SEC.

[77] *See, e.g.*, Letters from William E. Kramer, Assistant Vice President, Nomura Securities International, Inc. (July 15, 1994); A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Incorporated (July 14, 1994); and R. Fenn Putman, Chairman, PSA (June 21, 1994), to Jonathan G. Katz, Secretary, SEC.

[78] *See, e.g.*, Letters from Lawrence J. Latto, Shea & Gardner (June 17, 1994); and Peter C. Clapman, Sr. Vice President/Chief Counsel, College Retirement Equities Fund (June 15, 1994); to Jonathan G. Katz, Secretary, SEC.

[79] *See* Letter from Paul Schott Stevens, General Counsel, ICI, to Jonathan G. Katz, Secretary, SEC (June 15, 1994). *See also* Letter from Fred J. Franklin, Vice President/Chief Compliance Officer, Aetna Life Insurance and Annuity Co., to Jonathan G. Katz, Secretary, SEC (June 14, 1994).

[80] 15 U.S.C. 78O–5(a)(4).

[81] The legislative history of the Government Securities Act Amendments of 1993 discussed SIPC coverage and the exemption from SIPC coverage afforded to government securities brokers and dealers. The Government Accounting Office noted that the gap in SIPC coverage could be confusing to investors and recommended, among other things, that the lack of SIPC coverage be disclosed. The amendments ultimately took a disclosure approach and authorized the Commission to require disclosure of non-SIPC status of government securities brokers and dealers. S. Rep. No. 422, 103rd Cong., 1st Sess. 16 (1993). The same reasons to require this disclosure of government securities brokers and dealers applies to other broker-dealers that are exempt from SIPC coverage.

[82] Some commenters believed that the proposed disclosure was inconsistent with a letter, *Letter regarding Benjamin M. Vandegrift* (Dec. 21, 1993), issued by the Division of Investment Management. The disclosure requirement adopted today recognizes the position taken in the letter, reserving the right to revisit SIPC-related disclosure issues.

transfer agent.[83] The transfer agent then will issue shares to the customer against receipt of the purchase money and send the money to the fund's custodian bank. In this situation, customer funds are not handled by the broker-dealer. In addition, the ICI argued that the transfer agent or fund underwriter, when sending the confirmation on behalf of the broker-dealer, may not know the SIPC status of a particular broker-dealer. Accordingly, the disclosure provision contains an exclusion that is intended to apply only in cases where the non-SIPC broker-dealer does not receive or handle in any form customer funds or securities in connection with a purchase or redemption of registered open-end investment company or unit investment trust shares and the customer sends its purchase money or securities to the fund, its transfer agent, its custodian, or its designated agent, none of whom are associated persons of the broker-dealer. Furthermore, checks may not be made payable to the broker-dealer, and the broker-dealer may not handle any customer checks in connection with the transaction. Otherwise, the broker-dealer would be required to disclose its non-SIPC status. Therefore, if a broker-dealer, including a fund underwriter, receives customer funds or securities and promptly forwards funds or securities to the investment company, transfer agent, custodian, or other designated agent, the confirmation would have to disclose the non-SIPC status of the broker-dealer.

F. Disclosures Relating to Asset-Backed Securities

In 1983, the Commission adopted amendments to Rule 10b–10 to require disclosure of yield information on a customer confirmation, recognizing that such information is important to investors when evaluating the merits of investing in various debt securities.[84] Currently, Rule 10b–10 requires the disclosure of (1) the yield to maturity, if the transaction is effected on the basis of dollar price;[85] (2) the dollar price calculated from yield, if the transaction is effected on a yield basis;[86] and (3) if effected on a basis other than dollar price or yield to maturity, and the yield to maturity will be less than the represented yield, then both the yield to maturity and the represented yield.[87]

Rule 10b–10 exempts from the yield disclosure requirements any instrument that is a "participation interest in notes secured by liens upon real estate continuously subject to prepayment."[88] Since the adoption of the yield disclosure requirements, structured financings have expanded to include securities backed by mortgage notes, automobile loans, computer leases, consumer debt, and other receivables. These asset-backed securities raised similar problems of variable yield. Accordingly, the Commission proposed to expand the range of securities subject to the exemptions from yield disclosure to include asset-backed securities that are not insulated from prepayment risk or susceptible to an accurate forecast of yield.[89]

In addition, the Commission proposed to require particularized disclosures in connection with transactions in collateralized mortgage obligations ("CMOs").[90] Specifically, the Commission proposed amendments that would require broker-dealers to disclose on the confirmation the particular CMO's (1) estimated yield; (2) weighted average life; and (3) prepayment assumptions underlying the yield.[91]

Some commenters supported the Commission's proposal to require disclosure of CMO information and noted that such disclosures were provided to investors as a matter of course, either in a confirmation or other disclosure statements.[92] Other commenters opposed confirmation disclosure of the estimated yield, weighted average life, and prepayment assumptions on the grounds that the confirmation is not an appropriate disclosure vehicle to convey the information.[93] In addition, commenters opposed disclosing such complex information in a confirmation because it could not be accomplished in a meaningful way due to the document's limited size and space.[94] Many commenters noted that detailed discussions concerning particular aspects of CMOs are contained in the prospectus or other offering documents that are sent to investors prior to the time in which they make their investment decisions.[95]

No comments were received regarding the proposal to expand the range of instruments that would be exempted from the yield disclosure requirements. Because some instruments are not subject to predictable forecasts of the yield, the Commission is adopting amendments exempting asset-backed instruments that are continuously subject to prepayment. The exemption would apply only to those instruments that are not insulated from prepayment risk or otherwise susceptible to an accurate forecast of yield.[96]

In addition, in light of the comments concerning the proposed CMO disclosure, the Commission is modifying the amendment requiring the disclosure of prepayment assumptions, weighted average life, and estimated yield of a CMO. The Commission recognizes that broker-dealers intend confirmations to be brief, and thus size limitations may affect the detail of disclosure that may be practically and meaningfully conveyed to the customer.

---

[83] *See* Letter from Paul Schott Stevens, General Counsel, ICI, to Jonathan G. Katz, Secretary, SEC (June 15, 1994), at 2, n.5.

[84] *See* Securities Exchange Act Release No. 19687 (Apr. 18, 1983), 48 FR 17583.

[85] 17 CFR 240.10b–10(a)(4)(ii) and (5)(i).

[86] 17 CFR 240.10b–10(a)(5)(ii).

[87] 17 CFR 240.10b–10(a)(5)(iii).

[88] 17 CFR 240.10b–10(a)(4)(ii) and (5)(iii). Essentially, this exemption was aimed at mortgage pass-through notes that were issued or guaranteed by the Government National Mortgage Association, Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation.

[89] *See* Proposing Release, *supra* note ———, at 59 FR 12771.

[90] CMOs are collateralized pools of residential mortgage loans that are divided into multiple tranches (sometimes as many as 15 to 20) which can be tailored to a broad spectrum of investors or particularized to the cash flow needs of a single or discrete group of investors. Like other asset-backed securities, the rate of prepayment on the underlying collateral of CMOs is influenced by changes in interest rates and shifts in the general economy, which in turn may affect the actual maturities of CMOs as prepayment speeds accelerate or decrease. CMOs are priced on the basis of the estimated weighted average life of individual CMO tranches. As interest rates decline, prepayments increase, with a corresponding shortening of weighted average life. Conversely, an increase in interest rates results in a lengthening of maturity.

[91] Proposing Release, *supra* note ———, at 59 FR 12771.

[92] *See, e.g.*, Letters from David M. Beckius, Vice President/Sr. Attorney, Dean Witter Reynolds, Inc. (July 14, 1994); Silas L. Matthies, Sr. Vice President, Norwest Securities, Inc. (June 14, 1994); Rauscher Pierce Refsnes, Inc. (June 14, 1994); and Bill Duepree, Jr., President, Morgan Keegan & Co., Inc. (June 1, 1994), to Jonathan G. Katz, Secretary, SEC.

[93] Commenters noted that investors receive disclosure documents containing numerous models depicting different prepayment assumptions. These commenters questioned which of the multiple assumptions would be disclosed in the confirmation. *See, e.g.*, Letters from Robert F. Price, Chairman/Federal Regulation Committee, SIA (July 15, 1994); and R. Fenn Putman, Chairman, PSA (June 21, 1994), to Jonathan G. Katz, Secretary, SEC.

[94] *See, e.g.*, Letters from Robert F. Price, Chairman, Federal Regulation Committee, SIA (July 15, 1994); R. Fenn Putman, Chairman, PSA (June 21, 1994); and Mitchell Delk, Vice President Government and Industry Relations, Freddie Mac, (June 15, 1994), to Jonathan G. Katz, Secretary, SEC.

[95] *See, e.g.*, Letters from Kathryn S. Reimann, Sr. Vice President, Lehman Brothers, Inc. (July 14, 1994); R. Fenn Putman, Chairman, PSA (June 21, 1994); and Mitchell Delk, Vice President/ Government and Industry Relations, Freddie Mac (June 15, 1994), to Jonathan G. Katz, Secretary, SEC.

[96] This position codifies a no-action position in *Letter regarding Merrill Lynch, Pierce, Fenner & Smith* (Oct. 19, 1988), granting no-action with respect to the yield disclosure requirements for those mortgage and asset-backed securities that are not subject to an accurate forecast of yield. The staff noted that if an accurate forecast of yield could be made, then the yield should be disclosed in the confirmation.

Thus, while yield information is important to investors of CMOs, as well as all mortgage and asset-backed securities, the Commission agrees that these securities contain complexities that are difficult to explain using single figures in a confirmation. Accordingly, rather than require the disclosure in the confirmation of specific numbers identifying the estimated yield, weighted average life, and prepayment assumptions underlying the yield, the Commission is adopting a requirement that broker-dealers include on the confirmation a statement alerting investors that their yields are subject to fluctuation depending on the speed in which the underlying note or receivable prepays and that specific information is available upon written request of the customer.[97]

While information concerning prepayment assumptions and pricing of CMOs and other asset-backed securities may be contained in disclosure documents at the offering stage, this type of detailed information has not been as readily available in the secondary market for some asset-backed securities and to some investors.[98] Under the Rule, as adopted, such information would be required to be sent to customers upon written request. In addition, if in fact a CMO or other asset-back security is sold solely on the basis of one yield amount, the yield and underlying assumptions should be disclosed on the confirmation, as well as the legend stating that these items may vary.[99] This is consistent with those commenters that noted that they disclose yield information in CMO transactions as a matter of course.[100] The antifraud provisions of the federal securities laws would require that any information provided upon request reflect changes or developments in the characteristics of the asset-backed security.

III. Effects on Competition and Regulatory Flexibility Act Considerations

Section 23(a)(2) of the Exchange Act[101] requires that the Commission, when adopting rules under the Exchange Act, consider the anticompetitive effects of those rules, if any, and balance any anticompetitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission believes that adoption of the amendments to Rule 10b–10 will not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA") regarding the amendments to Rule 10b–10, in accordance with 5 U.S.C. 604. The FRFA notes the potential initial costs of operational and procedural changes that may be necessary to comply with the amendments. In addition, the FRFA notes the benefits to investors of increased disclosure that will result from these amendments. The Commission believes that the benefits of added disclosure outweigh the costs that will be incurred by industry participants in complying with these amendments.

A copy of the FRFA will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Statutory Basis and Text of Amendments

For the reasons set forth in the preamble, the Commission hereby amends Part 240 of Chapter II of Title 17 of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.10b–10 is amended by adding a preliminary note prior to paragraph (a), revising paragraphs (a) and (b), removing paragraph (c), redesignating paragraphs (d) through (f) as paragraphs (c) through (e), adding a heading to newly designated paragraph (d), revising the introductory text of paragraph (d) and the introductory text of paragraph (d)(6), and adding paragraph (d)(10) to read as follows:

§ 240.10b–10 Confirmation of transactions.

Preliminary Note. This section requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction. The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision.

(a) *Disclosure Requirement.* It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security (other than U.S. Savings Bonds or municipal securities) unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing:

(1) The date and time of the transaction (or the fact that the time of the transaction will be furnished upon written request to such customer) and the identity, price, and number of shares or units (or principal amount) of such security purchased or sold by such customer; and

(2) Whether the broker or dealer is acting as agent for such customer, as agent for some other person, as agent for both such customer and some other person, or as principal for its own account; and if the broker or dealer is acting as principal, whether it is a market maker in the security (other than by reason of acting as a block positioner); and

[97] This approach builds upon an alternative suggested by one commenter that rather than the proposed disclosure, the Commission impose a requirement that a broker-dealer print a legend on the confirmation. *See* Letter from Mitchell Delk, Vice President/Government and Industry Relations, Freddie Mac, to Jonathan G. Katz, Secretary, SEC (June 15, 1994).

[98] The Commission recognizes the positive efforts made to educate and provide information to investors in the CMO market. For example, the PSA developed a brochure entitled, "Investors Guide to Real Estate Mortgage Investment Conduits (REMICs)," which is approved by the NASD as an investor education tool. In addition, one commenter stated that prepayment information and interest rate information are available to dealers and investors in the secondary market through various vendors and proprietary services. This commenter also indicated that for those market participants that do not have access to this information, they should be able to obtain it from the selling broker-dealer. *See* Letter from Mitchell Delk, Vice President/Government and Industry Relations, Freddie Mac, to Jonathan G. Katz, Secretary, SEC (June 15, 1994).

[99] 17 CFR 240.10b–10(a)(5)(i). *See also* Securities Exchange Act Release No. 19687 (Apr. 18, 1983), 48 FR 17583. The Commission is concerned that in some cases asset-backed securities may be sold to retail investors on the basis of a single yield figure, without adequate disclosure that this yield can vary based upon prepayment speeds. This inadequate disclosure would potentially violate self-regulatory organization and Commission antifraud rules. In addition, to make this disclosure complete, a broker-dealer would need to disclose that the single yield may vary.

[100] *See supra* note 92.

[101] 15 U.S.C. 78w(a)(2).

(i) If the broker or dealer is acting as agent for such customer, for some other person, or for both such customer and some other person:

(A) The name of the person from whom the security was purchased, or to whom it was sold, for such customer or the fact that the information will be furnished upon written request of such customer; and

(B) The amount of any remuneration received or to be received by the broker from such customer in connection with the transaction unless remuneration paid by such customer is determined pursuant to written agreement with such customer, otherwise than on a transaction basis; and

(C) For a transaction in any subject security as defined in § 240.11Ac1–2 or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in Section 17B of this Act (15 U.S.C. 78q-2), a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and the fact that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer; and

(D) The source and amount of any other remuneration received or to be received by the broker in connection with the transaction: *Provided, however,* that if, in the case of a purchase, the broker was not participating in a distribution, or in the case of a sale, was not participating in a tender offer, the written notification may state whether any other remuneration has been or will be received and the fact that the source and amount of such other remuneration will be furnished upon written request of such customer; or

(ii) If the broker or dealer is acting as principal for its own account:

(A) In the case where such broker or dealer is not a market maker in that security and, if, after having received an order to buy from a customer, the broker or dealer purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the broker or dealer sold the security to another person to offset a contemporaneous purchase from such customer, the difference between the price to the customer and the dealer's contemporaneous purchase (for customer purchases) or sale price (for customer sales); or

(B) In the case of any other transaction in a reported security, or an equity security that is quoted on NASDAQ or traded on a national securities exchange and that is subject to last sale reporting, the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer.

(3) Whether any odd-lot differential or equivalent fee has been paid by such customer in connection with the execution of an order for an odd-lot number of shares or units (or principal amount) of a security and the fact that the amount of any such differential or fee will be furnished upon oral or written request: *Provided, however,* that such disclosure need not be made if the differential or fee is included in the remuneration disclosure, or exempted from disclosure, pursuant to paragraph (a)(2)(i)(B) of this section; and

(4) In the case of any transaction in a debt security subject to redemption before maturity, a statement to the effect that such debt security may be redeemed in whole or in part before maturity, that such a redemption could affect the yield represented and the fact that additional information is available upon request; and

(5) In the case of a transaction in a debt security effected exclusively on the basis of a dollar price:

(i) The dollar price at which the transaction was effected, and

(ii) The yield to maturity calculated from the dollar price: *Provided, however,* that this paragraph (a)(5)(ii) shall not apply to a transaction in a debt security that either: (A) Has a maturity date that may be extended by the issuer thereof, with a variable interest payable thereon; or

(B) Is an asset-backed security, that represents an interest in or is secured by a pool of receivables or other financial assets that are subject continuously to prepayment; and

(6) In the case of a transaction in a debt security effected on the basis of yield:

(i) The yield at which the transaction was effected, including the percentage amount and its characterization (*e.g.*, current yield, yield to maturity, or yield to call) and if effected at yield to call, the type of call, the call date and call price; and

(ii) The dollar price calculated from the yield at which the transaction was effected; and

(iii) If effected on a basis other than yield to maturity and the yield to maturity is lower than the represented yield, the yield to maturity as well as the represented yield; *Provided, however,* that this paragraph (a)(6)(iii) shall not apply to a transaction in a debt security that either:

(A) Has a maturity date that may be extended by the issuer thereof, with a variable interest rate payable thereon; or

(B) Is an asset-backed security, that represents an interest in or is secured by a pool of receivables or other financial assets that are subject continuously to prepayment; and

(7) In the case of a transaction in a debt security that is an asset-backed security, which represents an interest in or is secured by a pool of receivables or other financial assets that are subject continuously to prepayment, a statement indicating that the actual yield of such asset-backed security may vary according to the rate at which the underlying receivables or other financial assets are prepaid and a statement of the fact that information concerning the factors that affect yield (including at a minimum estimated yield, weighted average life, and the prepayment assumptions underlying yield) will be furnished upon written request of such customer; and

(8) In the case of a transaction in a debt security, other than a government security, that the security is unrated by a nationally recognized statistical rating organization, if such is the case; and

(9) That the broker or dealer is not a member of the Securities Investor Protection Corporation (SIPC), or that the broker or dealer clearing or carrying the customer account is not a member of SIPC, if such is the case: *Provided, however,* that this paragraph (a)(9) shall not apply in the case of a transaction in shares of a registered open-end investment company or unit investment trust if:

(i) The customer sends funds or securities directly to, or receives funds or securities directly from, the registered open-end investment company or unit investment trust, its transfer agent, its custodian, or other designated agent, and such person is not an associated person of the broker or dealer required by paragraph (a) of this section to send written notification to the customer; and

(ii) The written notification required by paragraph (a) of this section is sent on behalf of the broker or dealer to the customer by a person described in paragraph (a)(9)(i) of this section.

(b) *Alternative Periodic Reporting.* A broker or dealer may effect transactions for or with the account of a customer without giving or sending to such customer the written notification described in paragraph (a) of this section if:

(1) Such transactions are effected pursuant to a periodic plan or an investment company plan, or effected in shares of any open-end management investment company registered under

the Investment Company Act of 1940 that holds itself out as a money market fund and attempts to maintain a stable net asset value per share: *Provided, however,* that no sales load is deducted upon the purchase or redemption of shares in the money market fund; and

(2) Such broker or dealer gives or sends to such customer within five business days after the end of each *quarterly* period, for transactions involving investment company and periodic plans, and after the end of each *monthly* period, for other transactions described in paragraph (c)(1) of this section, a written statement disclosing each purchase or redemption, effected for or with, and each dividend or distribution credited to or reinvested for, the account of such customer during the month; the date of such transaction; the identity, number, and price of any securities purchased or redeemed by such customer in each such transaction; the total number of shares of such securities in such customer's account; any remuneration received or to be received by the broker or dealer in connection therewith; and that any other information required by paragraph (a) of this section will be furnished upon written request: *Provided, however,* that the written statement may be delivered to some other person designated by the customer for distribution to the customer; and

(3) Such customer is provided with prior notification in writing disclosing the intention to send the written information referred to in paragraph (c)(1) of this section in lieu of an immediate confirmation.

* * * * *

(d) *Definitions.* For the purposes of this section:

* * * * *

(6) *Investment company plan* means any plan under which securities issued by an open-end investment company or unit investment trust registered under the Investment Company Act of 1940 are purchased by a customer (the payments being made directly to, or made payable to, the registered investment company, or the principal underwriter, custodian, trustee, or other designated agent of the registered investment company), or sold by a customer pursuant to:

* * * * *

(10) *Asset-backed security* means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

* * * * *

By the Commission.

Dated: November 10, 1994.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94-28450 Filed 11-16-94; 8:45 am]

BILLING CODE 8010-01-P