

and interprets the rules that govern the secondary markets, and it ensures industry compliance with those rules.

13. **Answer: B.** Under the 1934 Act, all persons are subject to the general prohibition against the use of “any manipulative, deceptive, or other fraudulent device or contrivance” in connection with a securities transaction.
14. **Answer: C.** The Securities Investor Protection Act of 1970 was created after several broker-dealer firms failed and the investors they served lost their investments. The Act created the Securities Investor Protection Corporation (SIPC) to help protect investors’ investments and to prevent a similar financial crisis. SIPC provides limited insurance for the assets contained in investors’ accounts.

When a brokerage firm is a member of SIPC, it must pay into a general insurance fund used to meet customer claims in case of bankruptcy. Being a member of SIPC does not exempt a firm from other regulatory requirements.

CHAPTER TWO

General Supervision

(23 questions)

2.1. DEFINITIONS

As discussed above, the Securities Exchange Act of 1934 is a landmark law that regulates the reselling of securities. The 1934 Act’s mandate to regulate the secondary market covers the financial markets and market participants. These participants include broker-dealers, their representatives, and self-regulatory organizations. Thus, it is the 1934 Act that lays out the rules for who must register as a broker-dealer with the SEC.

Later, the Securities Acts Amendments of 1975 were put in place to regulate banks and broker-dealers that sell municipal securities.

Finally, Dodd-Frank was passed to provide rules for who must register as municipal advisors. These laws helped to define the following terms.

2.1.1. BROKERS AND DEALERS

A **broker** is any person engaged in the business of effecting securities transactions for the accounts of others. A **dealer** is any person engaged in the business of buying and selling securities for its own account (not including security-based swaps).

In this context, the term “person” includes a natural person, company, government, political subdivision, agency, or instrumentality of a government. A person in this context does not include a minor or an incompetent person.

Generally, broker-dealers are firms that perform the functions of both brokers and dealers—broker-dealers can be individuals, but they are usually companies. Under most circumstances, commercial banks are not included in the definition of broker or dealer. Banks are generally regulated under separate banking laws.

2.1.2. MUNICIPAL SECURITIES

Municipal securities are securities issued by city, state, or county governments or an

entity derived from local government, such as a school system or a water bureau. Municipal securities are generally sold in a public, over-the-counter market.

Under the Securities Act of 1933 and the Exchange Act of 1934, municipal securities are exempt from the registration and reporting required of most securities. This means that until the 1970s, the market for municipal securities and the market participants were largely unregulated.

Beginning in the 1970s, however, individual investors began trading municipal bonds in greater numbers. At the same time, new types of municipal securities were being created. The participation of banks as underwriters in the municipal securities market also became problematic. The New York City fiscal crisis, heightened by the failure of municipal securities underwriters to disclose that the city was near default, underscored the role banks played in the municipal securities market and spurred the federal government to action.

The Securities Acts Amendments of 1975 were enacted to regulate the banks and broker-dealers that were selling municipal securities. The amendments required banks and broker-dealers that underwrite and sell municipal securities to register with the SEC and created the MSRB to write rules specific to the municipal securities market.

2.1.3. MUNICIPAL ENTITIES AND OBLIGATED PERSONS

According to the MSRB, a **municipal entity** is defined as:

- Any agency, authority, state, or local government
- Any plan, program, or pool of assets sponsored or established by the state, agency, authority, or local government
- Any other issuer of municipal securities

The definition includes, but is not limited to, public pension funds, LGIPs, and other state and local governmental entities or funds, as well as participant-directed investment programs or plans, such as 529, 403(b), and 457 plans.

The term **obligated person** means any person committed by contract or other arrangement to support the payment of all or part of the obligations associated with an offering of municipal securities. This definition includes an issuer of municipal securities, which could be an individual but is usually an entity.

2.1.4. BANK DEALERS

According to the MSRB, a **bank dealer** is a municipal securities dealer that is a bank or a separately identifiable department or division of a bank engaged in municipal securities dealer activities. Activities of a bank that constitute municipal securities dealer activities include:

- Underwriting, trading, or sales of municipal securities
- Financial advisory or consultant services for issuers in connection with the issuance of municipal securities

- Processing or clearance activities with respect to municipal securities
- Research or investment advice with respect to municipal securities
- Any other activities that involve communication, directly or indirectly, with public investors in municipal securities
- Maintenance of records with respect to municipal securities activities

Under MSRB Rule G-1, a bank dealer must be under the direct supervision of an officer, appointed by the board of directors of the bank, who is responsible for its municipal securities activities. Further, all its records must be separately maintained from the facilities of the bank and readily accessible to independent examination and enforcement of MSRB rules.

2.1.5. MUNICIPAL SECURITIES DEALER

Collectively, all broker-dealers and bank dealers that underwrite, trade, and sell municipal securities are known as municipal securities dealers.

The 1934 Act defines a **municipal securities dealer** as any person, including a separately identifiable department or division of a bank, engaged in the business of buying and selling municipal securities for its own account. However, municipal securities dealers do not include:

- Those that buy or sell municipal securities for their own account, but not as part of a regular business (This allows individuals and firms to be able to trade in municipal securities for investment purposes without being called a municipal securities dealer.)
- Banks that only act as agents, not dealers (However, remember that a separate division or department of a bank that engages in municipal securities business may be deemed a municipal securities dealer.)

☒ **Example:** Big Bank is a commercial bank that sells 529 plans to its customers. It operates as an agent of 529 plans but not as an underwriter. It does not engage in any other municipal securities activities and does not trade for its own account. Big Bank would not need to register as a municipal securities dealer.

☒ **Example:** Medium Bank is the primary distributor of a 529 plan. It does not engage in any other municipal securities activities. As an underwriter of a 529 plan, Medium Bank would need to register as a municipal securities dealer.

☒ **Example:** Lucky Sports and Games is a sporting goods chain that invests its extra income into municipal securities. Lucky Sports and Games would not need to register as a municipal securities dealer, because it is trading in municipal securities for investment purposes and the retailer is not holding itself out as a municipal securities dealer.

☒ **Example:** Small Bank underwrites new issues of municipal securities. Because

the bank is engaging in municipal securities activities and using its own funds to underwrite the new issues, it will need to register as a municipal securities dealer.

2.1.6. MUNICIPAL ADVISORS

In 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act required municipal advisors to be registered with the SEC. Municipal advisors are defined in Section 15 of the Securities Exchange Act. A **municipal advisor** is any person or entity that provides advice to, or on behalf of, municipal entities or an obligated person. The advice is regarding municipal financial products or the issuance of municipal securities, including advice related to the structure, timing, and terms of those products or issues. This includes any advice regarding the investment of proceeds from a municipal issuance. Municipal advisors also include anyone who solicits municipal entities to invest in financial products or to issue municipal securities.

The municipal advisor has a fiduciary duty to the municipality, which means the municipal advisor must act in the municipality's best interests. In summary, municipal advisor activities include:

- Providing advice about municipal financial products
- Providing advice about the issuance of municipal securities
- Soliciting municipal entities to invest in financial products
- Soliciting municipal entities to issue municipal securities
- This includes any advice regarding the investment of proceeds from a municipal issuance.

Municipal advisors include financial advisors, third-party marketers, placement agents, solicitors, and finders.

Municipal advisors do not include municipal entities or their employees, municipal securities dealers serving as underwriters, or attorneys offering legal advice. Nor do investment advisers registered under the Investment Advisers Act of 1940 or their associated persons need to register as municipal advisors, as long as they do not give advice about issuing municipal securities.

2.1.7. CUSTOMERS

A **customer**, for purposes of municipal securities transactions, is defined by who it is not. In a municipal securities transaction, a municipal securities dealer acting in its professional capacity is not a customer. In addition, in the sale of a new municipal securities issue, the issuer is not a customer. A municipal securities dealer may be a customer, however, when the transaction does not involve municipal securities.

 **Example:** A city is issuing bonds to raise money for the construction of a school. A municipal securities dealer purchases some of the bonds and later sells some of these bonds to John to round out his investment portfolio. John is a customer. The

municipal securities dealer is not a customer, because the transaction involves municipal securities. The city is not a customer, because the transaction involves a new issue of its own securities.

If a dealer sells a municipal security to another dealer, neither the buyer nor the seller is a customer. Both are acting in a professional capacity and the transaction is known as a dealer transaction.

2.1.8. MUNICIPAL FUND SECURITIES

A **municipal fund security** is a fund of securities that is issued by a state or municipality. Investments in a municipal fund may consist of a wide variety of securities, including corporate stocks and bonds and government securities of every stripe. It is not to be confused with a municipal bond fund, which is a mutual fund consisting of municipal bonds. A municipal fund security is distinguished from the typical investment company by its issuer.

Because it is issued by a state or local government, it is exempt from the rules of the Investment Company Act of 1940. As such, it does not have to:

- Register with the SEC
- Prepare a prospectus
- Calculate and post its net asset value on a daily basis
- Include independent directors on its board

In addition, municipal fund securities are exempt from federal taxes and often state and local taxes. Municipal fund securities are subject to MSRB rules.

Examples of municipal fund securities are local government investment pools (LGIPs) and 529 college savings plans.

2.2. REGISTRATION RULES

Before participating in any municipal securities activities, brokers, dealers, and municipal securities dealers, as well as municipal advisors, must register with the SEC as per Exchange Act Section 15. A dealer can register by filing an application with the SEC. The SEC has 45 days in which to respond by either granting the registration or instituting proceedings to determine whether the registration should be denied. The SEC has broad authority to regulate dealers and can grant exemptions to certain rules where consistent with the public interest.

All non-bank dealers that do business in the securities industry must also register with FINRA.

2.2.1. REGISTRATION WITH THE MSRB

Once the SEC has approved the registration, the broker, dealer, or advisor must register

with the MSRB by filing a Form A-12 and pay an initial registration fee and annual registration fee.

A dealer or advisor may register by paying an initial fee of \$1,000 and submitting the information required on Form A-12. Dealers and advisors must update Form A-12 within 30 days if any of the information becomes inaccurate.

If a municipal securities firm stops engaging in municipal securities business, it must notify the MSRB in writing. If the firm wants to return to municipal securities business, it must pay the initial \$1,000 fee again.

Municipal securities dealers and advisors must also pay the MSRB an annual fee of \$1,000 for each fiscal year in which they are registered to conduct municipal securities activities. Note that the annual fee is required for each year a firm is registered, even if no municipal securities business is conducted that year. The purpose of the fee is to defray the costs of MSRB communication with firms qualified to conduct municipal securities business. Note that MSRB operations are financed by fees rather than tax collections.

The fee must be received by October 31 of the fiscal year for which it is paid. However, for any dealer that registers and pays its annual registration fee during the month of September, the annual registration fee for the following fiscal year, beginning in October, is waived.

Should the dealer or advisor fail to pay the initial fee, the SEC may suspend or revoke its registration upon the recommendation of the MSRB. In addition, dealers or advisors that fail to pay a fee assessed under the registration rules within 30 days of the invoice date may be required to pay a monthly late fee of \$25 and a late fee on the overdue balance until paid.

A dealer's registration with the MSRB becomes effective once the MSRB notifies the dealer that its Form A-12 is complete and its initial and annual fees have been received and processed. Once a dealer or advisor has successfully registered with the MSRB, the firm may use the designation "MSRB registered" in its advertising and on its website. A firm may not say it is a member of the MSRB, because it is not a member organization.

Exchange Act Section 15 also requires that the broker, dealer, municipal securities dealer, or municipal securities advisor, once registered, provide any information required by the MSRB, FINRA, or any other registered securities association within 15 days of the request, unless otherwise stipulated.

2.2.2. REQUIRED CONTACTS

Broker-dealers are required to designate several contact persons when they register with the MSRB. On Form A-12, the dealer must designate the following:

- Primary regulatory contact
- Master account administrator
- Billing contact
- Compliance contact
- Primary data quality contact

To facilitate communication between the broker-dealer and the MSRB, the dealer may also designate one or more of the following contacts:

- Optional regulatory contact
- Optional technical contact
- Optional data quality contact

A broker-dealer's primary and optional regulatory contacts must be registered Municipal Securities Principals (Series 53 or, in the case of a firm solely engaged in municipal fund securities business, a Series 51 or 53). These contacts must be authorized to receive official communications from the MSRB on behalf of the dealer. For municipal advisors, the primary and regulatory contacts are not required to be principals, but must be authorized to receive official communications from MSRB. A broker-dealer's billing contact must be authorized to receive invoices from the MSRB and respond to any inquiries from the MSRB regarding fees.

2.2.2.1. Change in Status

Dealers are required to notify the MSRB within 30 days if any information provided in Form A-12 becomes inaccurate. An updated Form A-12 must be submitted if a dealer changes the firm's name or address, modifies its activities, or stops engaging in municipal securities business for any reason. Dealers must also notify the MSRB of any expulsion or suspension from membership in a national securities exchange or registered securities association. Written notification must include a statement of the reasons for a dealer's change in status. Changes to business activities or registration status should be submitted by the dealer's primary regulatory contact, optional regulatory contact, or compliance contact.

Dealers also must comply with any request from the MSRB or other regulatory agency for information related to registration within 15 days.

2.2.2.2. Annual Affirmation

Within 17 business days following the end of the calendar year, broker-dealers and advisors must review and update the information submitted on Form A-12 and report changes electronically to MSRB. This annual affirmation must be completed by the dealer's primary regulatory contact, optional regulatory contact, or compliance contact. If a dealer first registers with the MSRB and submits Form A-12 during the annual affirmation period (beginning January 1 of each year and ending 17 business days later), then the dealer is not required to affirm Form A-12 during that period.

2.2.2.3. Availability of MSRB Rules

Every dealer must keep a copy of all MSRB rules in each office involved in municipal securities business. A dealer must make MSRB rules available to customers promptly upon request.

MSRB Rule G-29